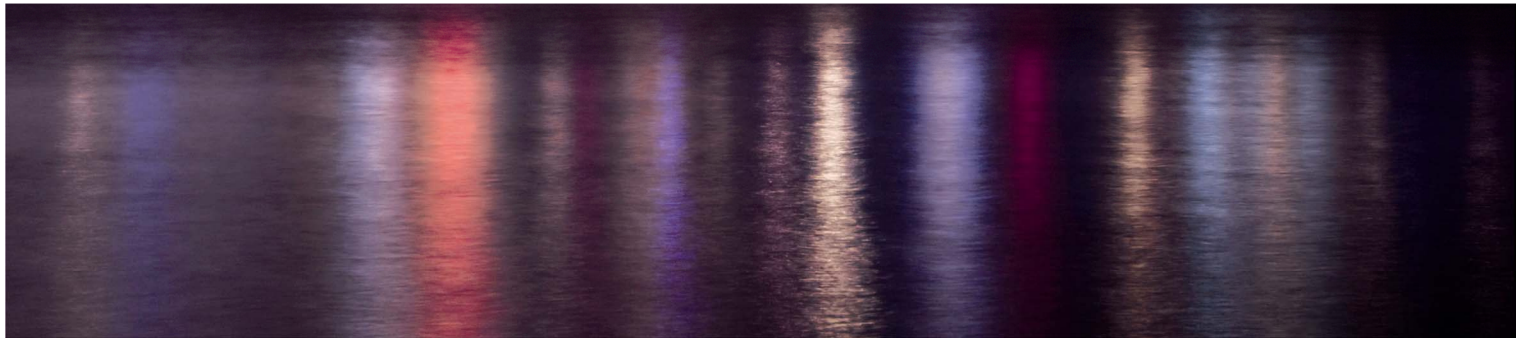




# OECD Economic Surveys KOREA

JUNE 2014

OVERVIEW



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# Summary

- *Main findings*
- *Key recommendations*

## Main findings

Korea has been among the fastest growing OECD countries during the past decade. However, subdued growth during 2011-12 revealed structural problems, such as high household debt, a lagging service sector and weak small and medium-sized enterprises (SMEs). This has raised concerns about Korea's traditional catch-up strategy led by exports produced by large *chaebol* companies. In addition, Korea has experienced a rise in relative poverty and income inequality since 1997, although both have fallen recently. The new growth strategy aims at fostering a “creative economy”, in which venture businesses play a key role, accompanied by greater emphasis on social cohesion, including increased social spending and a roadmap to boost employment. Such initiatives will support the current upturn, while promoting Korea's long-term convergence to the most advanced countries and enhancing social cohesion and well-being.

### Fostering a creative economy

While R&D spending was the highest in the OECD, at 4.4% of GDP in 2012, weaknesses in the innovation system limit the return. International collaboration in patenting and research is low and the role of universities is small. Framework conditions to promote a creative economy are also weak, reflecting relatively stringent product market regulations and low inward foreign direct investment. The creation of new enterprises is hampered by problems in the venture capital market and SME financing. The productivity gap between large firms and SMEs, which benefit from a wide range of public support, is widening, reflecting problems in services. Indeed, service sector productivity is only about half of that in manufacturing. Greenhouse gas emissions and energy intensity have been rising despite the 2009-13 green growth plan.

### Promoting social cohesion and well-being

Korea has a dualistic labour market, with non-regular workers accounting for a third of employment, contributing to high wage dispersion and low female labour participation. Public social spending as a share of GDP is less than half of the OECD average and has had a relatively small impact on income inequality and relative poverty, particularly among the elderly whose rate is 49%. Only about a quarter of the elderly receive benefits from the National Pension Scheme, reflecting its low coverage, while the company pension system is still at an early stage. Household debt, at 164% of disposable income, has a social dimension as financial institutions have become reluctant to lend to households with low income and poor credit ratings and the number of delinquent household borrowers remains sizable.

### Sustaining the economic expansion

Output growth has returned to close to 4%. However, Korea is vulnerable to the fragile global situation and exchange rate shifts, while high household debt poses a headwind to growth. The goal of balancing the central government budget (excluding social security) has been delayed until after 2017. The fiscal situation, nevertheless, remains strong with a general government budget surplus in 2012 and gross debt of only 34.8% of GDP. Inflation, which has fallen to 1%, is projected to rise to the target zone of 2.5%-3.5%.

## Key recommendations

### *Fostering a creative economy*

- Gradually scale back and streamline government support to SMEs, while concentrating it on firms at an early stage of development and avoiding long-term public support. Entry barriers to *chaebol*-affiliated firms should be phased out. Make the recently-established Korea New Exchange an important funding source for start-ups by ensuring an appropriate level of investor protection.
- Improve the innovation framework by expanding the role of universities, upgrading government research institutes and strengthening international linkages. Increase the return on investment in innovation by easing product market regulations, thereby facilitating the re-allocation of resources.
- Improve vocational education and training to meet the needs of SMEs and facilitate the use of the Internet to enhance their growth.
- Take further steps to improve the business environment. In particular, develop the service sector by leveling the playing field with manufacturing and strengthening competition by eliminating entry barriers, accelerating regulatory reform and reducing barriers to trade and FDI.
- Implement the Emissions Trading System as planned in 2015, align carbon taxation in sectors not covered by the System with the System and further raise electricity prices to at least cover production costs.

### *Promoting social cohesion and well-being*

- Break down labour market dualism by reducing employment protection for regular workers and by increasing social insurance coverage and training for non-regular workers.
- Raise the employment rate, particularly for women, by creating high-quality part-time jobs and improving the quality of childcare.
- Target the Basic Old-Age Pension benefit on the lowest-income elderly to ensure that they escape absolute poverty. Increase the coverage of the National Pension Scheme and maintain the replacement rate at around 50%. Raise the contribution rate to meet rising pension outlays. Expand company pensions and strengthen personal pension plans.
- Address the household delinquent debt problem while limiting moral hazard and containing the growth of household debt.

### *Sustaining the economic expansion*

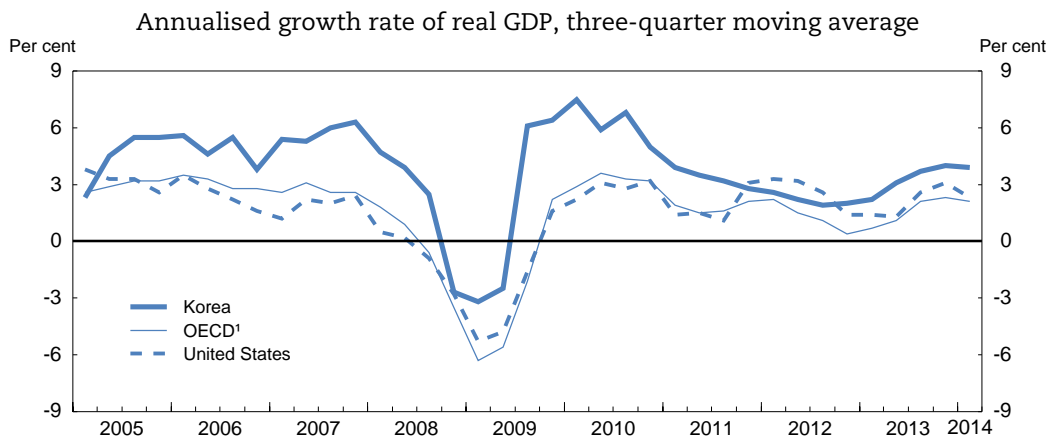
- Achieve the 2017 target of reducing the consolidated central government budget deficit (excluding the social security surplus) to close to zero, so long as the current expansion is sustained. If downside risks materialise, further relax monetary policy and implement short-term fiscal stimulus.
- Carefully consider the costs and benefits of any further accumulation of foreign exchange reserves.

## Assessment and Recommendations

- *Korea's economic expansion and macroeconomic policies to sustain it*
- *A new economic paradigm for Korea: Fostering a creative economy*
- *Promoting social cohesion and well-being*

Korea's economy has rebounded with growth at around 4% since mid-2013 (Figure 1). There is concern, though, that the problems that constrained growth during 2011-12 – weak domestic demand due to high household debt, stagnant service sector productivity and struggling small and medium-sized enterprises (SMEs) – will remain. Such concerns have raised doubts about the catch-up strategy that has fuelled Korea's development during the past 50 years. Reliance on exports appears to be losing its effectiveness as their trickle-down effect on domestic demand and employment has weakened (Bank of Korea, 2012a), prompting the government to look for other drivers of growth. Sustaining Korea's growth potential is essential to cope with population ageing, which is projected to be the most rapid in the OECD, and the cost of possible rapprochement with North Korea.

**Figure 1. Korea's economy has rebounded after a period of subdued output growth**



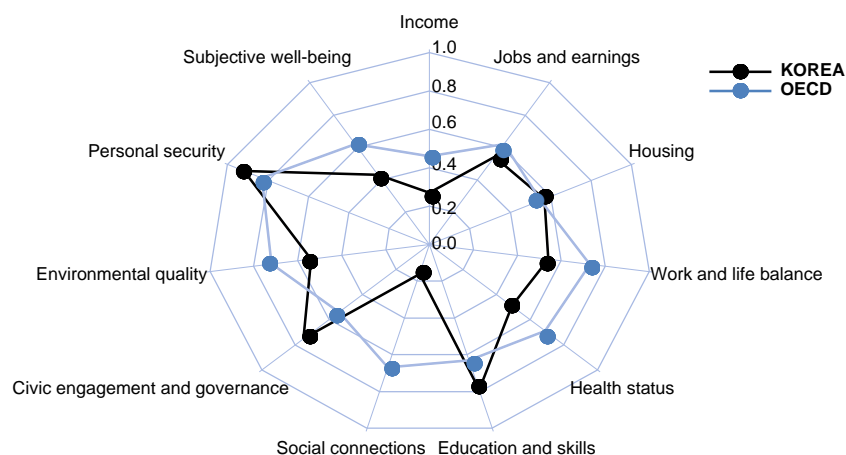
1. For the OECD, the first quarter of 2014 is on estimation.

Source: OECD *Economic Outlook*, No. 95.

In addition, inequality in Korea has gradually increased due to globalisation, technical progress, ageing and low public social spending. Moreover, Korea's traditional growth model is contributing to greater inequality by widening wage dispersion in favour of large companies, which account for around two-thirds of exports, and manufacturing. Korea's relative poverty rate is now the eighth highest in the OECD. In addition, Korea ranks visibly lower than the OECD average in six of the 11 categories of the OECD's well-being index (Figure 2).

Facing these challenges, the government has made fostering a “creative economy”, which is discussed in Chapter 1 of the *Survey*, a top priority. The goal is to shift Korea's economic paradigm to one based on innovation in which new start-ups and venture businesses play a key role (MOSF, 2013). In line with this goal, the government unveiled a comprehensive three-year innovation plan at the end of February 2014 (Annex A.1), which addresses many of the issues discussed in this *Survey*. Decisive implementation is essential to sustain Korea's growth potential. In addition, the new president, who styles herself as the “SME president”, wants to make smaller companies a driver of growth. To promote social cohesion, which is analysed in Chapter 2 of the *Survey*, the government plans to increase public social spending over the period 2013-17, while boosting employment to 70% of the working-age population. The employment objective reflects a growing emphasis on social welfare. Successfully implementing these initiatives would support the current expansion and Korea's convergence to the most advanced countries in the longer term, while enhancing social cohesion and well-being.

**Figure 2. Well-being indicators suggest a number of weaknesses in Korea<sup>1</sup>**



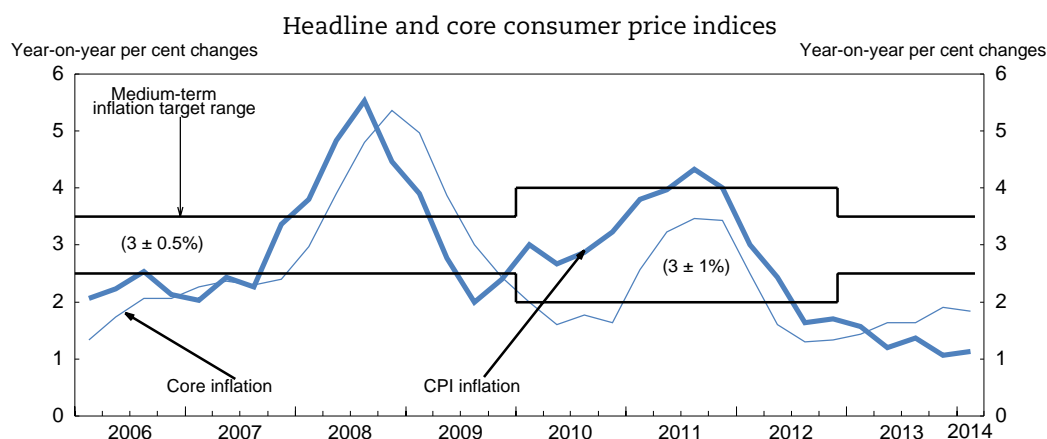
1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 1 (best) and 0 according to the following formula:  $(\text{indicator value} - \text{minimum value}) / (\text{maximum value} - \text{minimum value})$ .

Source: OECD (2013d).

## Korea's economic expansion and macroeconomic policies to sustain it

After two years of sluggish growth at an annual pace of around 2.5%, Korea rebounded during 2013, thanks in part to a pick-up in housing investment after seven straight years of decline and faster export growth in the first half of the year, which helped to sustain employment. Business and consumer confidence strengthened gradually, even though the exchange rate has appreciated 8% in real effective terms since mid-2013. The government launched a supplementary budget in 2013 and has delayed the 2014 target for balancing the consolidated central government budget (excluding social security) until after 2017, while promising to avoid any tax increases. Inflation has slowed to around 1%, well below the Bank of Korea's target range of 2.5% to 3.5% (Figure 3), reflecting sluggish growth and the fall in commodity prices. The Bank of Korea's policy rate has remained at 2.5% following a 25 basis point cut in May 2013.

**Figure 3. Inflation is well below the central bank's target range**



Source: OECD Analytical Database and Bank of Korea.



Korea faces headwinds from high household debt, which reached 164% of household disposable income at the end of 2012, well above the OECD average of 133%, and a weak property market. The high level of debt has kept private consumption growth below GDP growth each year since 2006. The government is addressing the household delinquent debt problem, notably through the “National Happiness Fund” launched in 2013 (see below). As for the property market, Korea avoided a housing-price bubble, leaving it, along with Japan, as the only OECD countries where real house prices in 2013 were below their 1995 and 2007 levels. With the removal of restrictive housing policies since 2008 and the launch of three housing packages in 2013, residential investment in 2013 rebounded, but was still 9% below its average over the past decade. Moreover, the erosion in real housing prices that began in 2012 is continuing.

Despite these headwinds, output growth of around 4% is projected in 2014-15 (Table 1). A moderate rebound in world trade will help Korean exporters overcome the appreciation of the won, which has gained 38% relative to the Japanese yen since 2012. The won-yen exchange rate is important as around two-thirds of Korean exports are thought to compete directly with Japanese products in world markets. Stronger exports are key to boosting business investment, which declined in 2013. Continued employment and wages gains, combined with some reversal in the rise in the household saving rate, are expected to boost private consumption, although it will continue to be restrained by high household debt. The pick-up in output growth is expected to boost inflation to nearly 3% in 2015, while narrowing the current account surplus to around 4½ per cent of GDP.

Domestic risks are largely on the upside insofar as government initiatives to address household debt and the housing sector could boost growth more than expected. However, Korea is particularly sensitive to the fragile global economic situation and exchange rate shifts, as exports account for more than half of GDP. The impact of yen depreciation could be larger than expected if Japanese firms shift their emphasis from boosting profit margins to regaining market share. While the direct impact from the tapering of US monetary policy on Korea is likely to be limited, the recent instability in a number of emerging economies poses another risk. If such downside risks materialise, Korea has scope to use monetary and fiscal stimulus to support growth, given its budget surplus in 2012 (on a general government basis) and low gross public debt of 34.8% of GDP (Table 1). The debt of state-owned enterprises was slightly higher at 39% of GDP at the end of 2012, but their assets are even greater at 57% of GDP. The debt-to-equity ratio of state-owned enterprises is to be reduced from 239% in 2013 to 200% in 2017 by streamlining their activities and selling assets as part of the Three-year Plan for Economic Innovation (Annex A.1).

Moreover, the government's net financial assets have risen to 35.9% of GDP in 2012, up from only 13% in 1988, when the National Pension Scheme (NPS) was established. This is largely due to the accumulation of assets by the NPS in an attempt to ease the burden of rising pension outlays as the share of elderly increases from 16% of the 15-to-64 population in 2012 (the fourth lowest in the OECD) to 71% in 2050 (the third highest). The social security surplus remains substantial at 2.8% of GDP in 2012 and continued surpluses are projected to push the National Pension Fund to 50% of GDP in 2035. The Fund will help finance public social spending, which is projected to rise from less than 10% of GDP in 2012 to 29% by 2060 under the current framework, according to the government. Short-term flexibility in fiscal policy should therefore be coupled with an effective framework to maintain fiscal soundness in view of upward spending pressures. The National Fiscal Management Plan sets targets for government spending and revenue, the budget balance and public debt for five years, as well as spending allocations by sector. The rolling plan, which is revised each year, is submitted to the National Assembly for discussion, although it does not require approval (2007 *OECD Economic Survey of Korea*). Ensuring Korea's long-run fiscal sustainability requires a stronger fiscal policy framework that includes fiscal rules.

Headline inflation has undershot the lower bound of the target range since mid-2012, although inflation expectations have remained stable around the 3% midpoint. If downside risks were to materialise, monetary easing might be appropriate. Under the projected recovery, however, inflation is expected to move back into the target range without additional monetary easing. As the recovery matures, monetary policy will need to tighten.

**Table 1. Macroeconomic indicators and projections<sup>1</sup>**

Annual percentage change unless specified otherwise, volumes at 2010 prices, based on SNA2008

	Per cent of 2010 GDP in current prices	2011	2012	2013	2014	2015
<b>GDP</b>	100.0	3.7	2.3	3.0	4.0	4.2
Private consumption	50.3	2.9	1.9	2.0	2.6	3.1
Government consumption	14.5	2.2	3.4	2.7	2.4	3.1
Gross fixed capital formation	30.5	0.8	-0.5	4.2	5.4	6.4
<i>Of which:</i>						
Housing	3.6	-8.0	-2.9	19.4	5.5	6.3
Business	22.3	3.4	0.7	-1.0	7.9	6.8
Government	5.2	-6.0	-3.9	3.5	3.2	3.1
Final domestic demand	95.3	2.1	1.4	2.8	3.4	4.1
Stockbuilding <sup>2</sup>	1.5	0.9	-0.6	-1.3	0.0	0.0
Total domestic demand	96.8	3.0	0.7	1.4	3.4	4.2
Exports of goods and services	49.4	15.1	5.1	4.3	5.9	8.5
Imports of goods and services	46.2	14.3	2.4	1.6	5.0	8.9
Net exports <sup>2</sup>	3.2	0.8	1.5	1.5	0.0	0.3
<b>Other indicators</b>						
Employment		1.7	1.8	1.6	1.8	1.6
Unemployment rate <sup>3</sup>		3.4	3.2	3.1	3.1	3.0
GDP deflator		1.6	1.0	0.7	0.7	1.1
Consumer price index (CPI)		4.0	2.2	1.3	2.0	2.8
Core CPI		3.2	1.7	1.6	2.3	2.8
Household saving rate <sup>4</sup>		3.9	3.9	5.1	5.2	5.3
Current account balance <sup>5,6</sup>		2.1	4.0	5.4	5.4	4.5
Government budget balance <sup>5,7</sup>		-1.0	-1.3	-1.5	-1.7	-1.1
General government financial balance <sup>5</sup>		1.0	1.0	-0.4	0.1	0.5
General government gross debt <sup>5</sup>		33.3	34.8	36.5	37.9	39.0
General government net debt <sup>5</sup>		-35.3	-35.9	-34.2	-32.8	-31.7
Three-month money market rate		3.4	3.3	2.7	2.8	3.9
Ten-year government bond yield		4.2	3.4	3.3	3.7	4.9

1. Historical data through 2013 for GDP and other indicators and projections from *Economic Outlook*, No. 95 (May 2014) for 2014-15.

2. Contributions to changes in real GDP (percentage of real GDP in previous year).

3. As a percentage of the labour force.

4. As a percentage of disposable income.

5. As a percentage of GDP.

6. Under the sixth edition of the Balance of Payments and International Investment Manual (PBm6) introduced in March 2014, the current account surplus was \$79.9 billion in 2013 (\$70.7 previously), amounting to 6.1% of GDP.

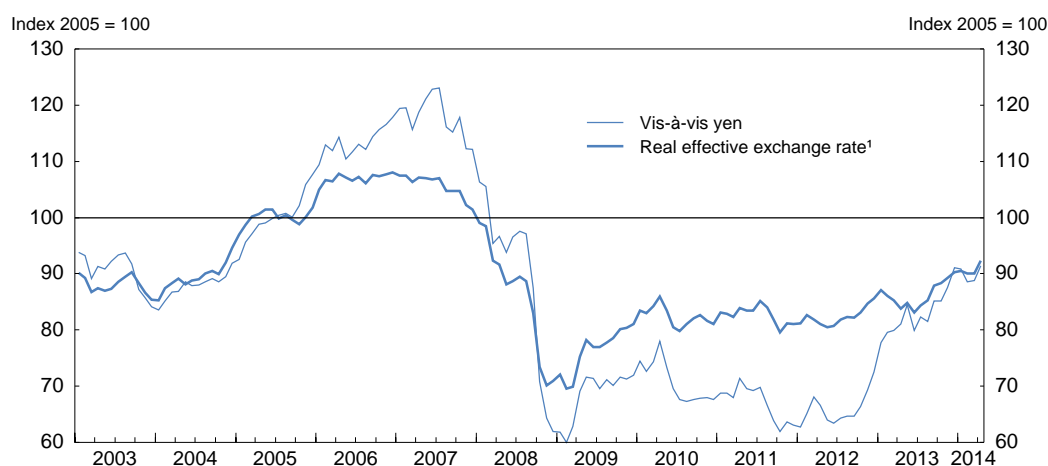
7. Consolidated central government budget, excluding the social security surplus. Figures for 2013-15 are the targets in the government's five-year plan.

Source: OECD *Economic Outlook* No. 95.

The pace of monetary tightening depends in part on the exchange rate (Figure 4). According to the IMF (IMF, 2014), the won is “moderately undervalued” in real effective terms, though such estimates are uncertain. The current account surplus rose from 2.5% of GDP in 2010 to 5.4% of GDP in 2013, one of the largest in the OECD, largely reflecting sluggish domestic demand growth and the fall in commodity prices. A stronger currency benefits consumers by reducing the price of imported goods while reducing the international competitiveness of exporters. Further won appreciation would thus benefit Korea by

rebalancing the economy toward domestic demand, one of the three main strategies of the Three-year Plan for Economic Innovation (Annex A.1), and have positive spillover effects on other countries, while reducing Korea's large current account surplus.

**Figure 4. The won has fluctuated widely**

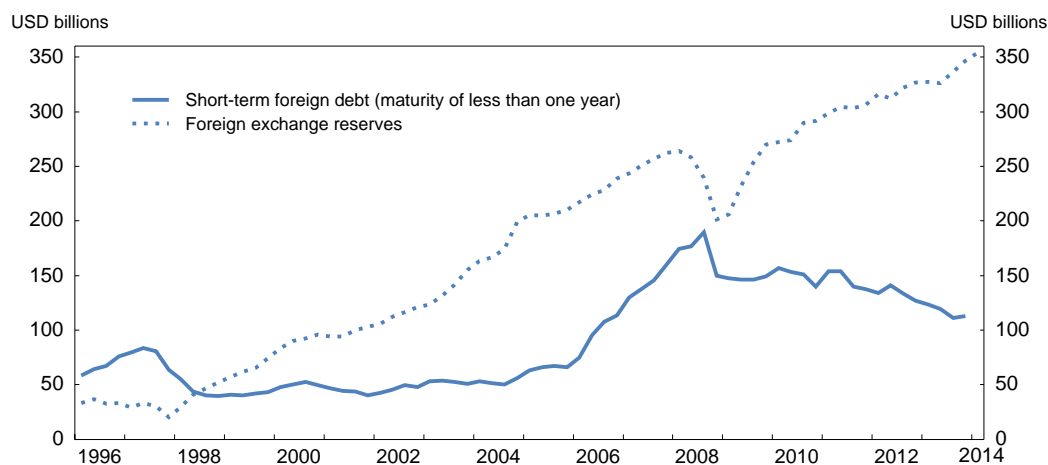


1. Trade-weighted, *vis-à-vis* 48 trading partners, calculated using consumer prices.

Source: OECD Analytical Database and Bank of Korea.

Korea's foreign exchange policy focuses on smoothing excessive volatility. Foreign exchange reserves rose from \$262 billion in 2007 to \$354 billion (26% of GDP) at the end of the first quarter of 2014 (Figure 5), which will help protect Korea against future crises. Korea has been particularly sensitive to external shocks, which caused capital flight and rapid currency depreciation during the 1997 and 2008 crises. In addition, reserves reduce the cost of foreign borrowing. Korea's reserves are now more than three times greater than short-term foreign debt, which has fallen from a peak of \$189 billion at the end of 2008 to \$113 billion at the end of 2013, due in part to the introduction of macro-prudential measures to curb the volatility of capital flows. These include the 2011 levy on non-deposit foreign currency liabilities of domestic banks and foreign bank branches. In addition, a regulation on banks' foreign exchange derivative positions was introduced in 2010. The OECD's Investment Committee is now assessing the conformity of this regulation with the OECD Code of Liberalisation of Capital Movements.

**Figure 5. Foreign exchange reserves are three times higher than short-term foreign debt**



Source: Bank of Korea.

In addition to the benefits of holding reserves noted above, there are also costs and risks. Foreign exchange reserves are a costly way to try to gain protection against foreign exchange volatility, as they are typically invested in safe assets with low returns. The fiscal costs, reflecting the difference between the interest received on reserves and that paid on instruments issued to finance or sterilise the reserves, are significant. In addition, sizeable holdings of foreign assets can entail foreign exchange risk. Instead, swap agreements, which played a key role in resolving Korea's foreign exchange shortage in 2008, can supplement foreign exchange reserves, although they depend on the co-operation of other countries. Korea maintains swap agreements with Japan and China and has recently reached agreements with Australia and Indonesia. In addition, it is important to continue building a transparent and sound financial system to maintain investor confidence and better absorb shocks from abroad.

#### **Box 1. Macroeconomic policy recommendations**

- Achieve the 2017 target of reducing the consolidated central government budget deficit (excluding the social security surplus) to close to zero, so long as the current expansion is sustained. If downside risks materialise, further relax monetary policy and implement short-term fiscal stimulus.
- Carefully consider the costs and benefits of any further accumulation of foreign exchange reserves.

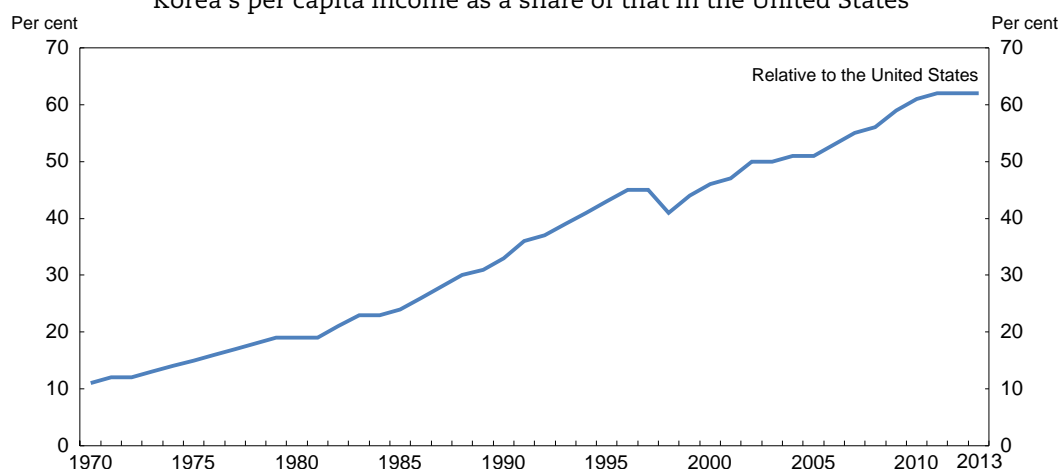
### **A new economic paradigm for Korea: Fostering a creative economy**

Double-digit export growth in volume terms during the past 20 years has made Korea the seventh-largest exporter and 15<sup>th</sup>-largest economy in the world. By 2011, Korea's per capita income reached 62% of that in the United States (Figure 6). This was achieved primarily by increasing inputs; over the period 1970-2000, labour and capital contributed 4.3 percentage points to the 7.6% average annual increase in national income (Table 2). However, their contribution fell to 1.7 points to an annual growth rate of 4.6% over 2000-10 and is likely to fall further as the working-age population begins shrinking in 2017 and working time declines further from its still high level. The Korea Development Institute estimates that Korea's potential growth rate will fall from around 4% on a per capita basis to 2¼ per cent in the 2030s. To slow the fall in potential growth and further narrow the income gap with the most advanced countries, productivity needs to be boosted through greater creativity and innovation, calling for:

- Improving the innovation system to maximise the return on Korea's large investment in R&D.
- Attracting new players, notably venture businesses and SMEs, into innovation.
- Focusing innovation and new players on new fields, such as services and green growth.

**Figure 6. Korea has achieved rapid economic development**

Korea's per capita income as a share of that in the United States<sup>1</sup>



1. GDP per capita, converted at 2005 purchasing power parity exchange rates. The data for Korea are based on SNA1993, as SNA2008 data are not available prior to 2000, while those for the United States are based on SNA2008. Using SNA2008 for Korean GDP in 2013 would raise Korea per capita income from 62% of the US level to 68%.

Source: OECD National Accounts Database.

**Table 2. Sources of Korean growth**

Contribution in percentage points

	1970-2000	1970-1980	1980-1990	1990-2000	2000-2010
National income growth (%)	7.6	7.8	9.3	5.8	4.6
Total inputs	4.3	5.0	5.1	3.0	1.7
Labour	2.7	3.1	3.4	1.8	1.0
Capital	1.6	1.9	1.7	1.1	0.8
Productivity gains	3.3	2.8	4.2	2.8	2.9

Source: Kim et al. (2012).

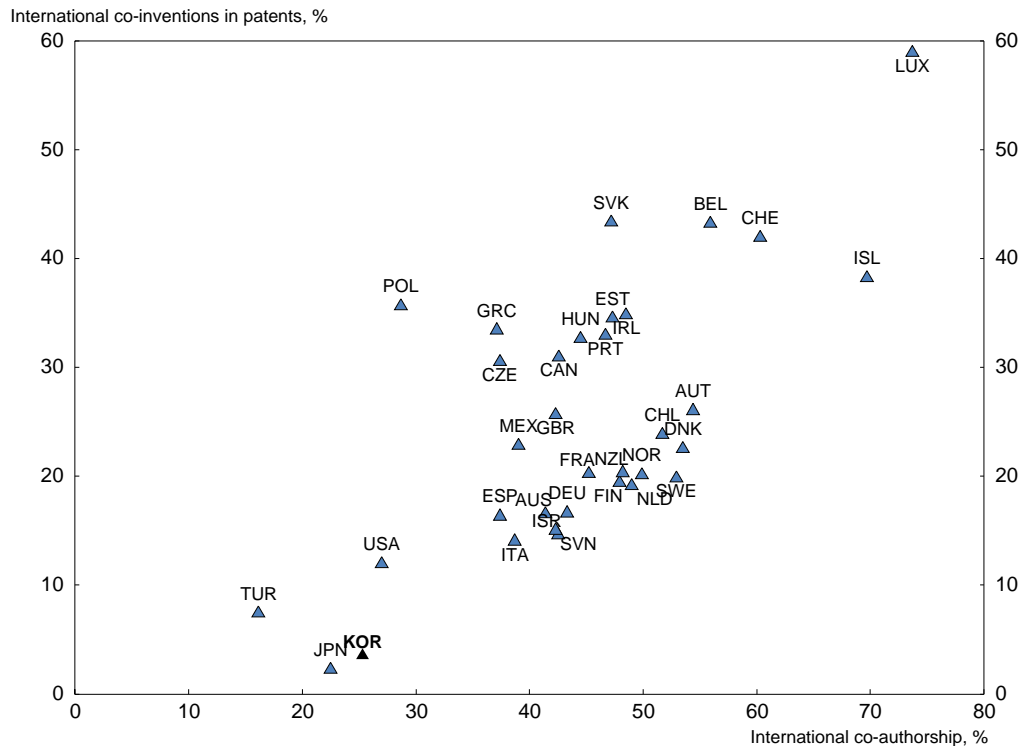
### *Improving the innovation system*

R&D spending in Korea was the highest in the OECD, at 4.4% of GDP in 2012, with the business sector accounting for three-quarters of the total. Business R&D, which typically has a significant impact on multifactor productivity growth (Westmore, 2013), was concentrated in large firms, while enterprises with less than 250 workers accounted for only 24% of the total, compared to the OECD average of 33% (OECD, 2013g), contributing to low productivity in SMEs.

Another weakness is the small role played by universities, which performed only 10% of R&D in Korea in 2011, about half the OECD average, despite employing three-quarters of the country's PhDs. Only 5% of company patents cite university-developed technology, compared to around 9% in Canada and the United States. Business leaders cite a lack of trust between enterprises and universities (OECD, 2014a). The modest role of universities also limits basic research, which is becoming more important as Korea approaches the technology frontier in many fields. Enhancing universities' role in innovation requires greater university-business co-operation in various areas, including accreditation and curricula (Jones, 2013).

**Figure 7. Korea's international linkages in science and innovation are weak**

In 2007-11



Source: OECD (2013g).

Another challenge is to raise the quality of public R&D, which is vast and complex; in 2011, there were 41 619 government-funded R&D projects, with total spending exceeding 1% of GDP. Of the total, more than one-third went to the 27 government research institutes (GRIs). However, their contribution has not met the expectations of the private sector, which has upgraded its R&D capabilities. To improve returns from GRIs, it is important to clearly define their role, improve their steering and incentives and enhance co-operation between GRIs, universities and corporate research labs. Finally, Korea ranks low on measures of international collaboration in innovation (Figure 7), as few foreign researchers and students come to Korea.

### *Framework conditions to promote a creative economy*

The return on investment in knowledge depends on the allocation of resources to make the most of such knowledge (Andrews and Criscuolo, 2013). Korea ranks low in allocative efficiency, based on the extent to which firms with high productivity attract workers (OECD, 2013f). Allocative efficiency depends, in turn, on a range of factors that determine the strength of competition: *i)* product market regulations, in which Korea was the second most restrictive in the overall index among OECD countries in 2013 (Koske et al., 2014); *ii)* inflows of foreign direct investment (FDI); *iii)* competition policy; *iv)* labour mobility; and *v)* SME policies, which can delay restructuring and distort resource allocation (see below).

Regulatory reform is a key part of the Three-year Plan for Economic Innovation (Annex A.1). The total burden of regulation is to be capped and eventually reduced, in part by strengthening the sunset clause for existing regulations. In addition, a cabinet committee headed by the president is to be launched to promote deregulation. Boosting the stock of FDI, which was the third lowest in the OECD area, at 14% of GDP in 2013, is another priority. Korea's index of barriers to trade and investment was the highest in the OECD area in 2013. In addition to reducing explicit barriers, it is necessary to improve the business environment, in part by reducing government intervention in the economy, and pursuing regulatory reform.

## Attracting new players in innovation

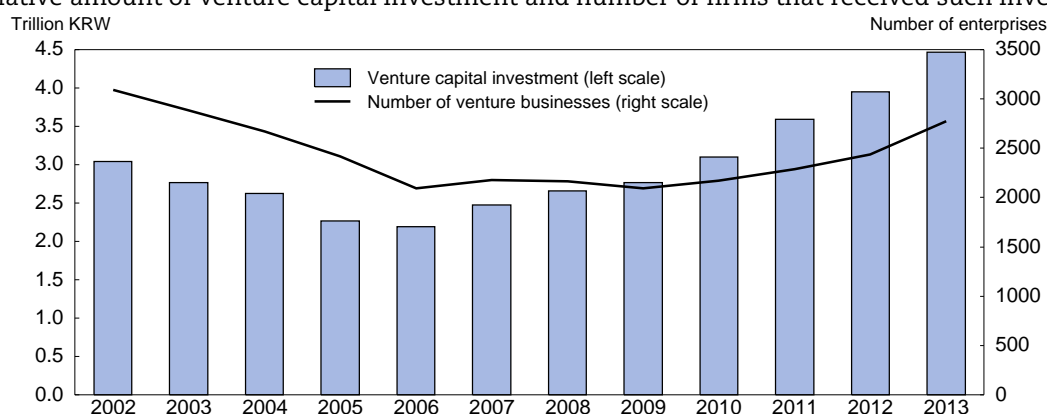
### Promoting venture businesses and start-ups

Venture businesses and start-ups play a key role in commercialising new technology and creating jobs (Andrews and de Serres, 2012). Firms less than five years old, regardless of their size, accounted for less than a fifth of total non-financial business employment but generated half of all new jobs over 2001-11 (OECD, 2013g). After declining following the collapse of the ICT bubble in the early 2000s, the cumulative amount of venture capital investment in Korea more than doubled over 2006-13 (Figure 8). While the number of firms that have received venture investment remains less than in the early 2000s, it has also been on an upward trend since 2009. Korea's venture capital market, on a flow basis, was the third largest in the OECD at 0.1% of GDP in 2011 (OECD, 2013b).

Nevertheless, the venture capital market is still at an early stage of development, accounting for less than 1% of SME financing (Table 3), and faces a number of weaknesses. *First*, the number of business angels, who play a crucial role at an early stage of start-ups, has plummeted from nearly 29 thousand before the collapse of the ICT bubble to 4 870 in 2013. *Second*, with the decline in the number of business angels, government money accounted for 33% of the venture capital market in 2012, with an additional 12% share for public pension funds. *Third*, venture investment is not focused on start-ups. Indeed, 55% of firms receiving venture capital investment are over three years old and 27% more than seven years old. *Fourth*, Korea's merger & acquisition (M&A) market is underdeveloped. Instead, initial public offerings (IPOs) are the primary method for venture capitalists to realise returns from their investment, despite demanding listing requirements. On average, it takes more than 14 years for start-ups to be listed on KOSDAQ, far exceeding the lifespan of most venture capital funds.

**Figure 8. Korea's venture capital market has rebounded in recent years**

Cumulative amount of venture capital investment and number of firms that received such investment



Source: SMBA and Korean Venture Capital Association (2013).

**Table 3. Sources of SME financing**  
As a per cent of the total<sup>1</sup>

Year	Banks	Non-banks	Bonds and equities	Venture investment	Government guarantees	Other government	Total
2004	61.1	22.7	0.6	1.2	13.6	0.8	100.0
2006	64.0	22.7	0.8	0.8	11.0	0.7	100.0
2008	68.0	21.0	0.8	0.7	8.9	0.6	100.0
2009	64.7	21.0	1.0	0.7	11.7	1.0	100.0
2010	64.5	20.7	0.7	0.8	12.3	1.1	100.0
2011	67.8	17.2	0.5	0.9	12.3	1.4	100.0

1. Government guarantees are assumed to cover bank lending. Some of the lending by government institutions is reported as loans by banks and non-banks.

Source: Sohn and Kim (2013).



To address these weaknesses, the government has launched initiatives to: *i)* promote angel investment and introduce crowd-funding (small investments by a large number of investors typically through social networking via the Internet); *ii)* develop the market for M&As involving venture businesses and business angels; and *iii)* encourage reinvestment by both successful and failed entrepreneurs. Korea's success in this area depends in part on the ability of the Korea New Exchange (KONEX) established in 2013 to facilitate IPOs involving ventures and start-ups. KOSDAQ was created in 1996 with this objective, but strict investor protection reduced the number of new companies listing on KOSDAQ from 171 in 2001 to only 21 in 2012. It is necessary to carefully balance investor protection in KONEX with the objective of facilitating IPOs. As venture capital follows, rather than precedes, the availability of attractive opportunities, the most severe constraint may be a lack of good investment proposals. Finally, it is important to foster entrepreneurship, an objective that is analysed in the skills strategy that the OECD is preparing for Korea (OECD, 2014b).

As part of the Three-year Plan For Economic Innovation (Annex A.1), the government will establish 17 “Creative Economy Innovation Centres” in major cities by 2015. The Centres are to become the focal point of regional development by supporting start-ups through a range of services including education, technology development and financing. Such Centres could play a role similar to Israel's “Incubators” programme that was launched in the early 1990s to provide intensive attention to individual projects from a very early stage, thus enabling the realisation of risky projects that would otherwise be unable to attract private capital. In addition to private and public financing, the Israeli programme provides business and marketing advice and infrastructure. Projects accepted into the programme are re-evaluated after one year to ensure that only the most promising continue to receive assistance (OECD, 2009).

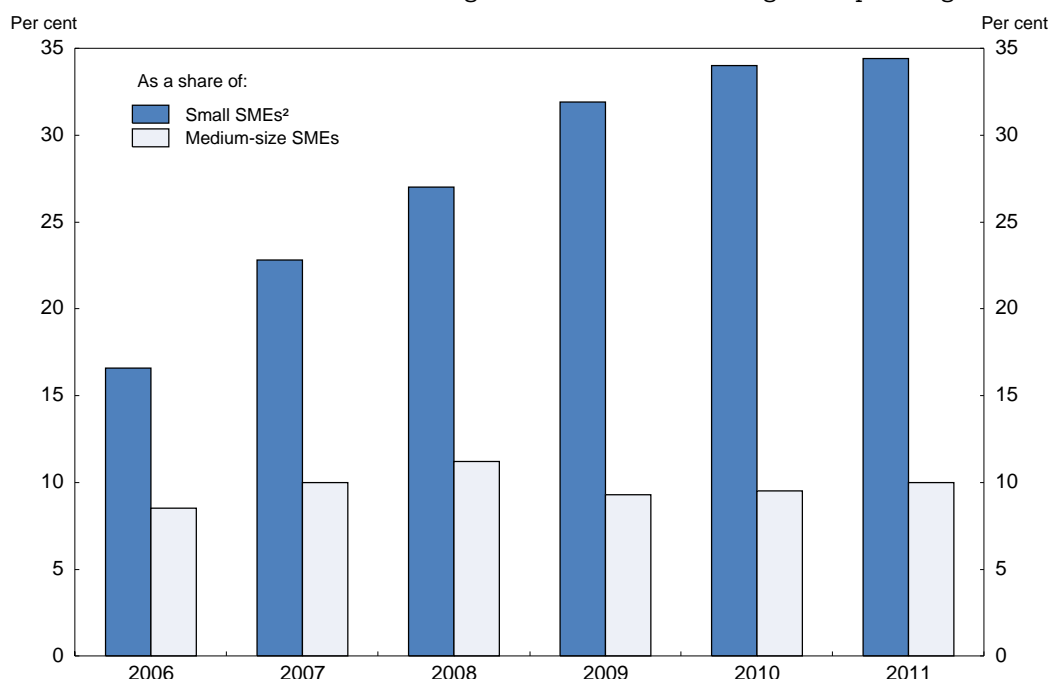
### *Revitalising the SME sector*

The productivity gap between large companies and SMEs (in the manufacturing sector, they are defined as companies with less than 300 workers), is large and growing; output per worker in SMEs fell from 33% of large companies in 2000 to 28% by 2011. In any given year, about one-third of SMEs which account for 87% of total employment, have an interest-coverage ratio of less than 100%, meaning that their earnings (before interest and taxes) are insufficient to cover their interest payments. Many such firms nevertheless survive for extended periods due in part to government support and “evergreening” of loans by financial institutions. Of firms with an interest-coverage ratio below 100% over 2000-02, 63% were still operating in 2010 with a ratio still below 100% (Bank of Korea, 2012b). The performance of smaller SMEs is particularly weak, as more than one-third had an interest-coverage ratio of less than 100% or negative operating cash flows during the preceding three years (Figure 9).



**Figure 9. The performance of small SMEs in Korea has been deteriorating**

The share of SMEs with an interest coverage ratio below 100% or negative operating cash flows<sup>1</sup>



1. During the preceding three years.

2. Firms with annual sales of less than 10 billion KRW (\$9.6 million).

Source: BOK (2012b).

### Improving SME policies and promoting market-based financing

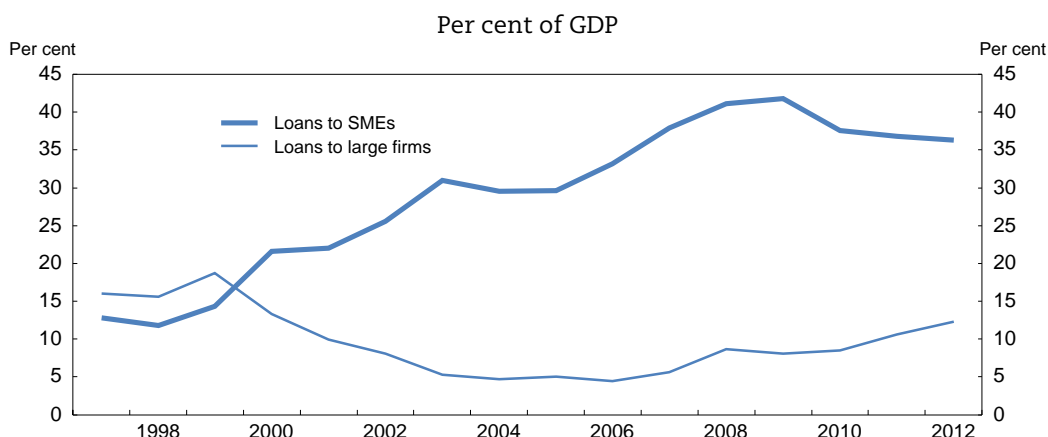
Public support to smaller firms, including the direct provision of loans and credit guarantees, is generous in Korea. Credit guarantees covered 12% of bank loans to SMEs in 2011, well above the 5% OECD average (OECD, 2013c). Public support, combined with the deleveraging of large firms following the 1997 crisis, has sharply boosted bank lending to SMEs from 13% of GDP to 36% in 2012 (Figure 10). SMEs receive three-quarters of business-sector loans, one of the highest shares in the OECD.

While government policies are needed to help overcome market failures that limit SME financing (OECD, 2013b), generous government support for SMEs has negative side effects:

- It hinders financial market development by reducing financial institutions' incentives to develop credit evaluation and risk management skills and instead encourages them to rely on credit guarantees. In Korea, guarantees generally cover 85% of loans, but up to 100% in some cases. SMEs also prefer government loans, which are easier to obtain and carry interest rates below market levels.
- It can delay the restructuring of SMEs.
- The high leverage of SMEs raises financial-sector risks. Although banks are highly capitalised and their substandard-and-below loans are steady at below 2% (Figure 11), bank profits are low.
- The generosity and long duration of public support encourages SMEs to remain small, thereby foregoing the efficiency gains and economies of scale associated with growth. Of the several million SMEs in 2002, only 696 expanded into mid-sized companies (defined as 300 to 999 workers) by 2012 (Statistics Korea, 2013).

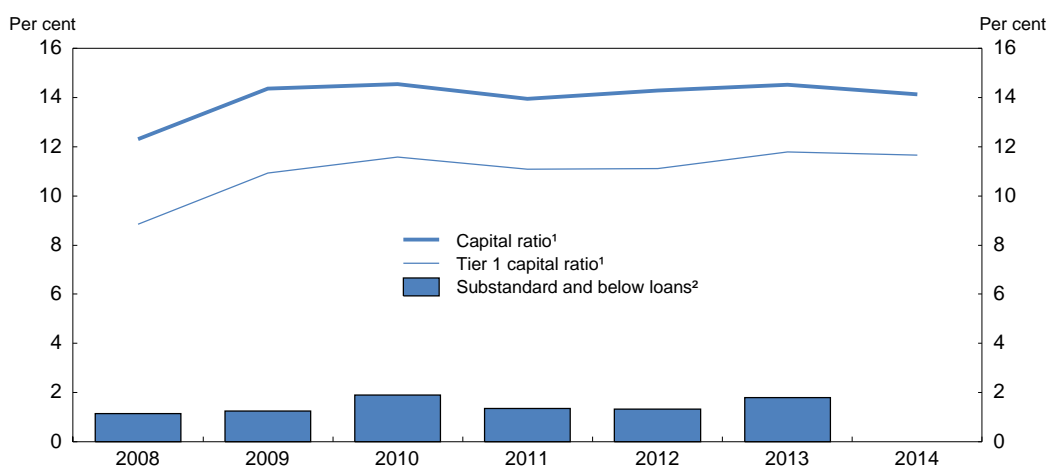
- It has little impact on firm performance. A study comparing SMEs receiving support to those that did not over 2003-09 found that public support failed to boost profits and sales (KDI et al., 2011).

**Figure 10. Commercial bank loans to SMEs have risen sharply**



Source: OECD (2013c).

**Figure 11. Korea's banking sector is well-capitalised**



1. As a share of total risk-weighted assets. The figures for 2014 are for March.

2. Includes loans classified as substandard, doubtful and presumed loss.

Source: Financial Supervisory Service.

In Korea, some of the objectives of SME policies, such as enhancing social cohesion and promoting new growth engines, would be better addressed through other instruments. SME support should instead focus on market failures that limit private-sector financing. In addition, support should be streamlined by drastically reducing the number of programmes. In 2013, 14 central government ministries ran 201 programmes, while the 16 provincial governments and 130 SME-related organisations administered another 1 101 programmes. This has resulted in duplication and waste, in part by allowing firms to receive multiple benefits from the government.

Public support should be concentrated on start-ups and venture businesses, which struggle most to obtain financing. However, about one-half of the guarantees from the two major public institutions were to SMEs older than ten years. Introducing a strict graduation rule would prevent firms from becoming dependent on long-term support. SME programmes should be made more market-oriented by raising interest rates on government loans closer to market levels and lowering the coverage ratio of the

guarantees, which is relatively high in Korea. Finally, market-based lending should be expanded by developing the necessary infrastructure and encouraging small non-bank financial institutions to lend more to small firms.

Reform of the SME sector has been hindered by concern that it would reduce its role in providing a social safety net to compensate for low public social spending and the early age at which employees leave firms. Indeed, the mandatory retirement age set by firms is 57 on average and many employees are pushed out even earlier. Many departing employees open small businesses, particularly in service industries requiring low skills and little capital. However, such necessity-driven entrepreneurship results in low productivity. Developing the social safety net and raising the retirement age set by firms should go hand-in-hand with reform of the SME sector.

### Making greater use of the Internet

In addition to lowering barriers to entrepreneurship, the Internet makes it easier to grow and manage a business. SMEs can compete more effectively with large firms by leveraging the Internet to lower fixed costs and outsourcing many aspects of their business. For example, cloud computing allows firms to obtain computing resources without costly and time-consuming upgrades of their infrastructure. In addition, the Internet can reduce transaction costs, which tend to be more burdensome for SMEs, and enhance price transparency, thereby strengthening competition. As a frontrunner in ICT, Korea is well placed to use the Internet to help small firms compete and grow. However, taking full advantage of this resource requires an appropriate regulatory framework and ICT skills for both entrepreneurs and for the general population to benefit from new services offered on the Internet (OECD, 2014c).

### Labour mismatches: ensuring appropriate human capital for SMEs

Korea is well known for its high educational attainment; it ranked first in math and second in reading among OECD countries in the 2012 Programme for International Student Assessment (OECD, 2013h) and nearly three-quarters of high school graduates enter tertiary education. However, graduates tend to avoid jobs in small firms. According to a 2011 government survey, 43% of small firms faced a labour shortage and another 40% expected to face one. Firms blamed shortages on the lack of qualified job applicants, their high expectations and the low wages and benefits offered by SMEs. To reduce the SME labour shortage, it is necessary to overcome the mismatch in the labour market. In 2011, 24% of youth with tertiary education were “neither in employment nor in education or training”. It is essential to reduce the overemphasis on higher education by improving vocational education, and by expanding training that meets the needs of SMEs (see the chapter on sustaining Korea's convergence to the highest-income countries in the 2012 *OECD Economic Survey of Korea*, or Jones and Urasawa, 2012c). The introduction of Meister schools since 2008 has contributed to the upgrading of vocational education at the secondary level and facilitated school-to-work transitions. Such reforms have helped reduce the share of high school graduates advancing to tertiary education from 84% in 2008 to 71% in 2010.

### Competition from chaebol-affiliated firms

SME weakness is sometimes blamed on the major role played by business groups (NCCP, 2013). After some consolidation following the 1997 crisis, the number of *chaebol*-affiliated companies is once again increasing, as the groups look for new growth opportunities, fuelling criticism that they are encroaching on markets traditionally dominated by SMEs. Such concerns have led the Korea Fair Trade Commission (KFTC), the competition authority, to implement new measures, including a ban on new circular shareholding between *chaebol* affiliates and tighter regulations on trading within the groups. Given the difficulty of enforcing such rules, the government should also focus on improving corporate governance of *chaebols* to ensure that non-controlling shareholders are not expropriated by the founding families. In addition, the subcontracting law was strengthened to prevent unfair practices by large firms against their suppliers. Around one-half of SMEs supply *chaebol*-affiliated firms. In principle, market forces should promote “win-win” co-operation between SMEs and *chaebols*, as large firms' success in global competition depends in part on mutually-beneficial relationships with suppliers.

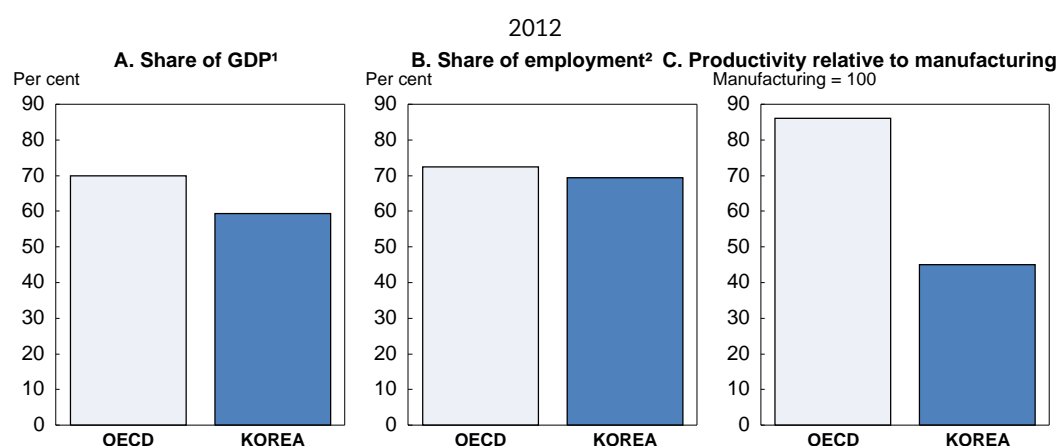
To promote balanced growth between large firms and SMEs, the National Commission for Corporate Partnership, a private committee, launched negotiations in 2011 among enterprises on business areas to be restricted to SMEs. It was agreed to reserve 100 business lines, such as restaurants, bakeries and car repair, for SMEs for three to six years. However, preventing the entry of large firms from important markets, many in services, and restricting their expansion in markets where they are already operating reduces aggregate productivity and consumer welfare. Rather than reducing their domestic opportunities, the government should make the domestic market attractive for all firms, including *chaebols*, whose share of domestic employment fell from 18% in 1995 to 12% in 2010 as they internationalised their operations. Given that some SMEs will be unable to compete, it is essential to further develop the social safety net and raise the retirement age from firms to reduce the supply of low-productivity SMEs, as noted above.

### *Focusing innovation and new players on new fields*

#### *Making the service sector a second driver of growth*

Manufacturing-led development has siphoned capital, talent and other resources away from services. By 2012, service sector productivity was only 45% of that in manufacturing, far below the OECD average of 86% (Figure 12). While manufacturing has raised output by improving productivity, services have grown by adding employees (McKinsey, 2013). Low productivity in the service sector also reflects its small (9% in 2011) and declining share in business R&D, putting it well below the OECD average of 38%. The weakness of Korea's service sector limits its contribution to exports, as shown by the OECD's new data on trade in value-added (TiVA) (Figure 13).

**Figure 12. Service sector productivity is low in Korea**



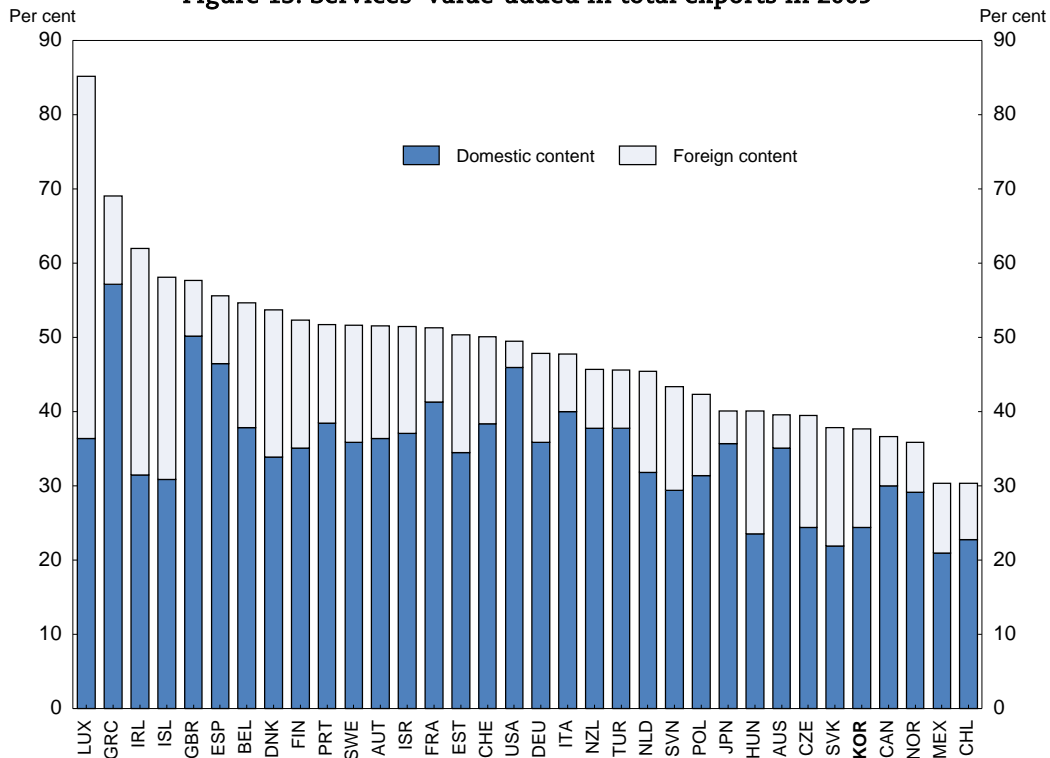
1. Gross value-added at basic prices.

2. Including self-employed.

Source: OECD National Accounts Database and OECD STI Database.

Converging to the income levels in the most advanced countries requires making services a second driver of growth. The first priority is to level the playing field by eliminating policies favouring manufacturing, such as lower tax rates and electricity prices. To that end, a comprehensive quantification of the various forms of support to manufacturing would be helpful. In addition, a stronger exchange rate would tend to promote the development of non-tradable services.

Figure 13. Services' value-added in total exports in 2009



Source: OECD (2013e).

The “2013 Service Industry Policy Directions and Measures” aims to: *i)* end tax discrimination; *ii)* improve the public-sector financial support system; *iii)* enhance the social image of services; *iv)* foster human capital in services; and *v)* provide support for service sector start-ups. However, the key framework condition to raise service productivity is stronger competition. As the government noted five years ago in launching a plan to nurture the service sector, “overly strict regulations are also obstructing investment and competition” in services (MOSF, 2009). Competition would be strengthened by eliminating entry barriers, accelerating regulatory reform and liberalising barriers to trade and FDI. Finally, the problems in services are linked to the weaknesses of SMEs (see the chapter on boosting productivity in services in the 2008 *OECD Economic Survey of Korea*, or Jones, 2008a). The government is also launching efforts to develop specific services, including health care, software and tourism, based on specific reforms in each area.

### Green growth and environmental objectives

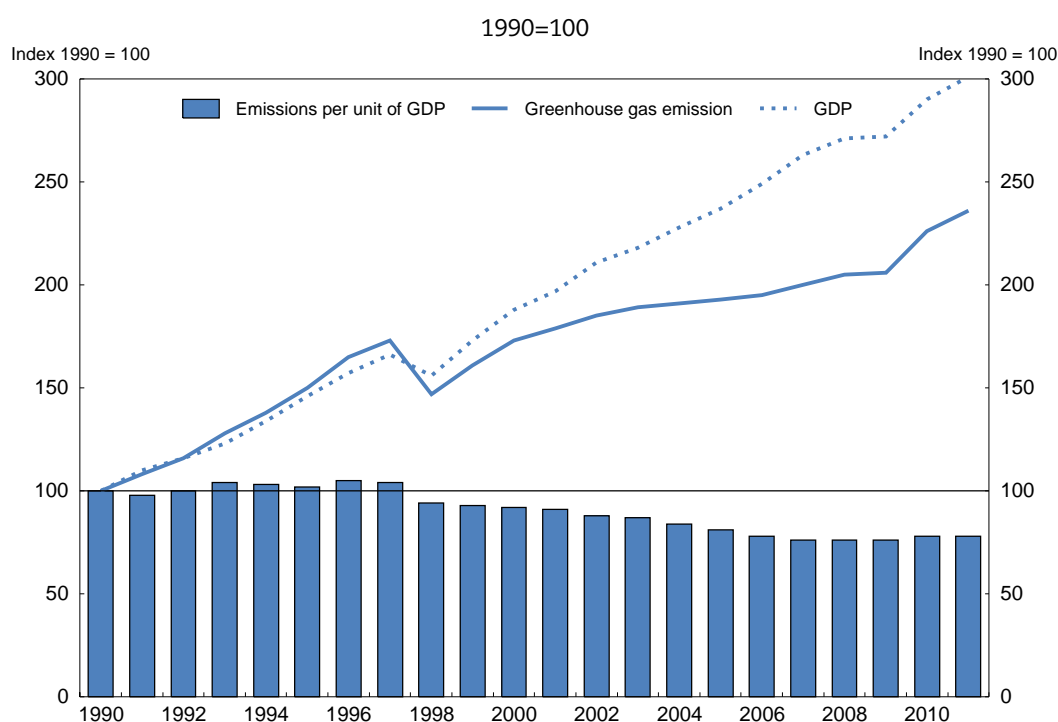
Green growth can play a central role in the development of a creative economy, as green technology and employment is set to be a global growth area in the decades ahead. In 2008, Korea's President proclaimed “Low Carbon, Green Growth” as the nation's vision to guide development during the next 50 years and launched the Five-Year Plan for Green Growth (2009-13), which was to cost 10% of 2009 GDP. Korea set an objective of reducing greenhouse gas (GHG) emissions by 30% by 2020 relative to a “business as usual” scenario, which implies a 4% cut from the 2005 level. Despite the large-scale spending on green growth, GHG emissions have risen 18% over 2007-11, reversing the downward trend in the ratio of emissions to GDP that began in 1997 (Figure 14).

The top priority to promote green growth and reduce GHG emissions is to follow through on the plan to establish an Emissions Trading System (ETS) in 2015. Achieving the 2020 target through an ETS would cost only 40% as much as relying on direct regulations (Lee, 2009). The share of permits that is auctioned, set at 3% over 2018-20, will be increased to more than 10% in the 2020s, as grandfathering permits provides windfall profits for existing firms, potentially resulting in unfair competition for new entrants.

Firms accounting for two-thirds of national emissions will be covered by the ETS by 2015. It would be preferable to expand the ETS as this would ensure a uniform price on emissions, or alternatively align carbon taxation with the ETS. It is also essential to raise electricity prices, which are relatively low compared to other OECD countries, to at least match production costs, thereby curbing energy use and GHG emissions. Indeed, electricity consumption per unit of GDP in Korea in 2009 was 1.7 times higher than the OECD average. A package of reforms to promote competition in the electricity sector would be beneficial, while promoting green growth (OECD, 2012a).

The 2014-18 green growth plan currently being prepared should be based on a careful analysis of the 2009-13 plan. The 27 core green technologies that the government selected in 2009 to guide investment decisions are being reconsidered, in light of mixed results, illustrating the difficulties of such targeting to guide private investment (see the chapter on green growth in the 2012 *OECD Economic Survey of Korea*, or Jones and Yoo, 2012). In addition to the potential economic gains from green growth, it would improve the quality of life by reversing the environmental degradation that accompanied rapid industrialisation. Indeed, air quality in Korea's capital region is among the worst in the OECD and the human health cost of air pollution caused by fine particulate matters were estimated at 1% of GDP in 2012 (Im et al., 2012).

**Figure 14. Greenhouse gas emissions are rising in Korea**



Source: OECD Environment Database and OECD Analytical Database.

### Box 2. Key policy recommendations to foster a creative economy

#### Attracting new players in innovation

- Gradually scale back and streamline government support to SMEs, while concentrating it on firms at an early stage of development and introduce a graduation system to prevent long-term public support. Entry barriers to *chaebol*-affiliated firms should be phased out.
- Make the recently established Korea New Exchange an important funding source for start-ups by ensuring an appropriate level of investor protection.
- Improve vocational education and training to meet the needs of SMEs and facilitate the use of the Internet to enhance their growth.

#### Improving the innovation framework

- Improve the innovation framework by expanding the role of universities, upgrading government research institutes and strengthening international linkages. Increase the return on investment in innovation by easing product market regulations, thereby facilitating the re-allocation of resources.

#### Focusing innovation and new players on new fields

- Take further steps to improve the business environment. In particular, develop the service sector by leveling the playing field with manufacturing and strengthening competition by eliminating entry barriers, accelerating regulatory reform and reducing barriers to trade and FDI.
- Implement the Emissions Trading System as planned in 2015, align carbon taxation in sectors not covered by the System with the System and further raise electricity prices to at least cover production costs.

## Promoting social cohesion and well-being

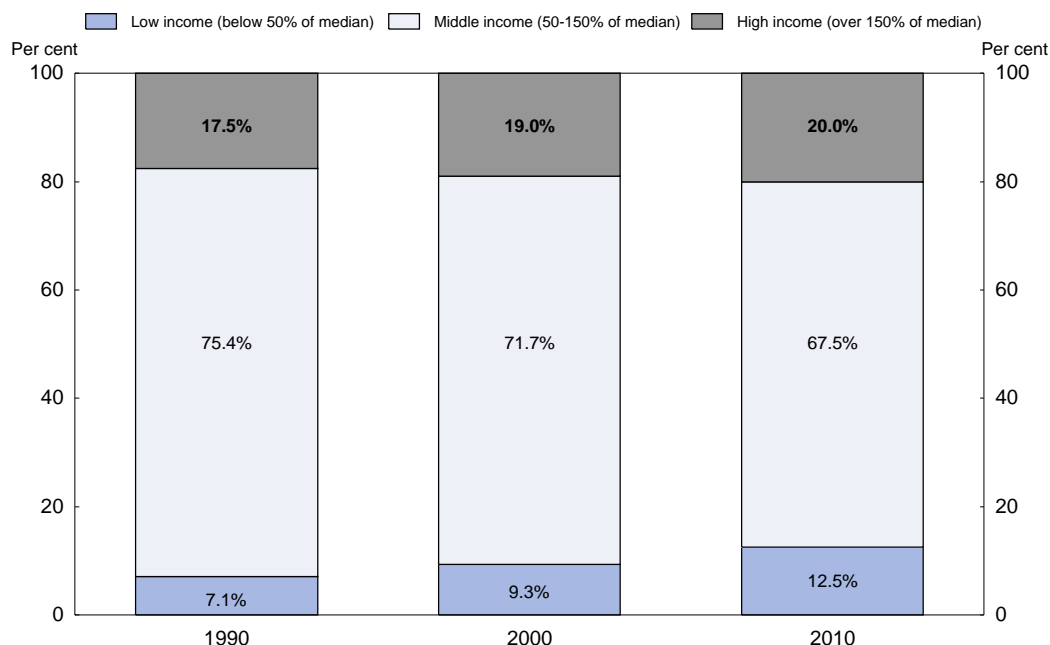
Korea has experienced a marked rise in income inequality and relative poverty since the 1997 crisis. By 2009, the ratio of the top to the bottom income quintile had risen to 5.7, the tenth highest in the OECD, while relative poverty was 15%. Rising inequality has squeezed the middle class from 75.4% in 1990 to 67.5% in 2010 (Figure 15). The policy directions discussed above to foster a dynamic economy should help reduce income inequality and poverty by making the SME sector a driver of growth and by raising productivity and wages in services to narrow the gap with manufacturing. In addition to reducing income inequality and poverty, social cohesion requires addressing exclusion and marginalisation by boosting employment, reforming education and resolving the high level of household debt and credit delinquency. This section focuses on:

- Breaking down labour market dualism, which would also help boost growth by reducing labour market turnover and encouraging firm-based training.
- Achieving the government's target of a 70% employment rate, in part by boosting female employment.
- Strengthening the social welfare system.
- Reforming education to promote social cohesion.
- Reducing the high rate of poverty among the elderly.
- Resolving the high level of household debt and credit delinquency, thus removing a significant headwind to output growth.



**Figure 15. Increased income inequality has squeezed the middle class**

The middle class is defined as those with an income between 50% and 150% of the national median



Source: Korea Institute of Health and Social Affairs.

## *Policies to reduce inequality and promote social mobility*

### *Labour market policies*

The key priority is to break down dualism in the labour market, which is severely segmented between regular and non-regular workers. In addition, raising the employment rate from 64% of the working-age population to 70% by 2017 is a top government priority.

### *Reforms to break down labour market dualism*

Non-regular workers accounted for one-third of employment in 2012. Firms hire non-regular workers to increase employment flexibility because regular workers receive relatively high employment protection as a result of government policies, business practices, social customs and labour unions (Koh et al., 2010). The share of temporary workers in Korea (24%), who account for a majority of non-regular workers, was double the OECD average in 2012. Even though regular and non-regular workers have comparable skills (OECD, 2013j), there is a large wage gap between them (Jones and Urasawa, 2012a). Consequently, almost a quarter of full-time workers in 2012 earned less than two-thirds of the median wage, the second-highest share in the OECD, and overall earnings dispersion was the third highest (Figure 16). Labour market dualism has a number of other negative implications for non-regular workers: *i*) less coverage by the social safety net; *ii*) precarious employment and the highest rate of worker turnover in the OECD; and *iii*) less access to training. The limited mobility between regular and non-regular employment (OECD, 2013i) reinforces the negative effect dualism on social cohesion.

To reduce dualism, the government has tried to contain the use of non-regular workers, in particular by limiting their employment to two years. However, according to government statistics for 2010-13 on fixed-term workers who had worked 18 months or more and whose employment contract had expired, around one-half (66% at large firms) leave their firm when their contract ends. Consequently, the number of non-regular workers has remained high and job turnover has increased, compared to the past

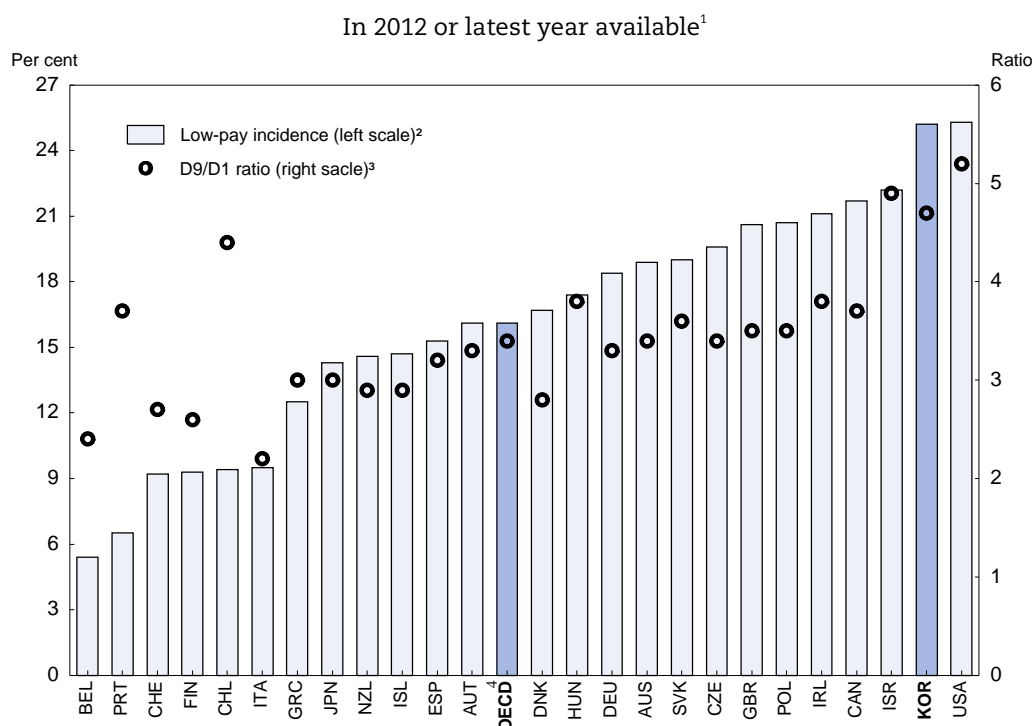


when many fixed-term workers had their contracts rolled over. Rather than restricting the use of non-regular workers, breaking down dualism requires a comprehensive strategy that reduces firms' incentives to hire non-regular workers, notably by relaxing employment protection for regular workers, and by upgrading training programmes and increasing social insurance coverage for non-regular workers (see the chapter on promoting social cohesion in the 2012 *OECD Economic Survey of Korea*, or Jones and Urasawa, 2012b).

### Implementing the roadmap to boost the employment rate to 70%

Korea's employment rate has levelled off at close to the OECD average. To achieve the 70% target, the roadmap calls for developing a creative economy that facilitates start-ups, thereby boosting employment. In addition, the plan aims to create more part-time jobs, encourage flexible work schedules and reduce working hours, which are still more than one-fifth above the OECD average of 1 769 hours per year. A decline in working hours would improve work-life balance (Figure 2) and help lift the fertility rate, the lowest in the OECD (Yamaguchi and Youm, 2012). Raising employment will depend, in part, on reducing labour market mismatches that limit youth employment, as discussed above, and extending the careers of older workers in firms (Table 4).

**Figure 16. Korea has a wide wage dispersion and a high share of low-wage workers**



1. Includes only those countries for which both indicators are available.
2. The share of full-time workers earning less than two-thirds of median earnings, including bonuses.
3. The ratio of the upper bound value of the 9<sup>th</sup> decile to the upper bound value of the 1<sup>st</sup> decile for full-time workers.
4. Unweighted average of the countries shown above.

Source: OECD Earnings Distribution Database.

**Table 4. The employment rate targets set by the roadmap**

As a per cent of the working-age population

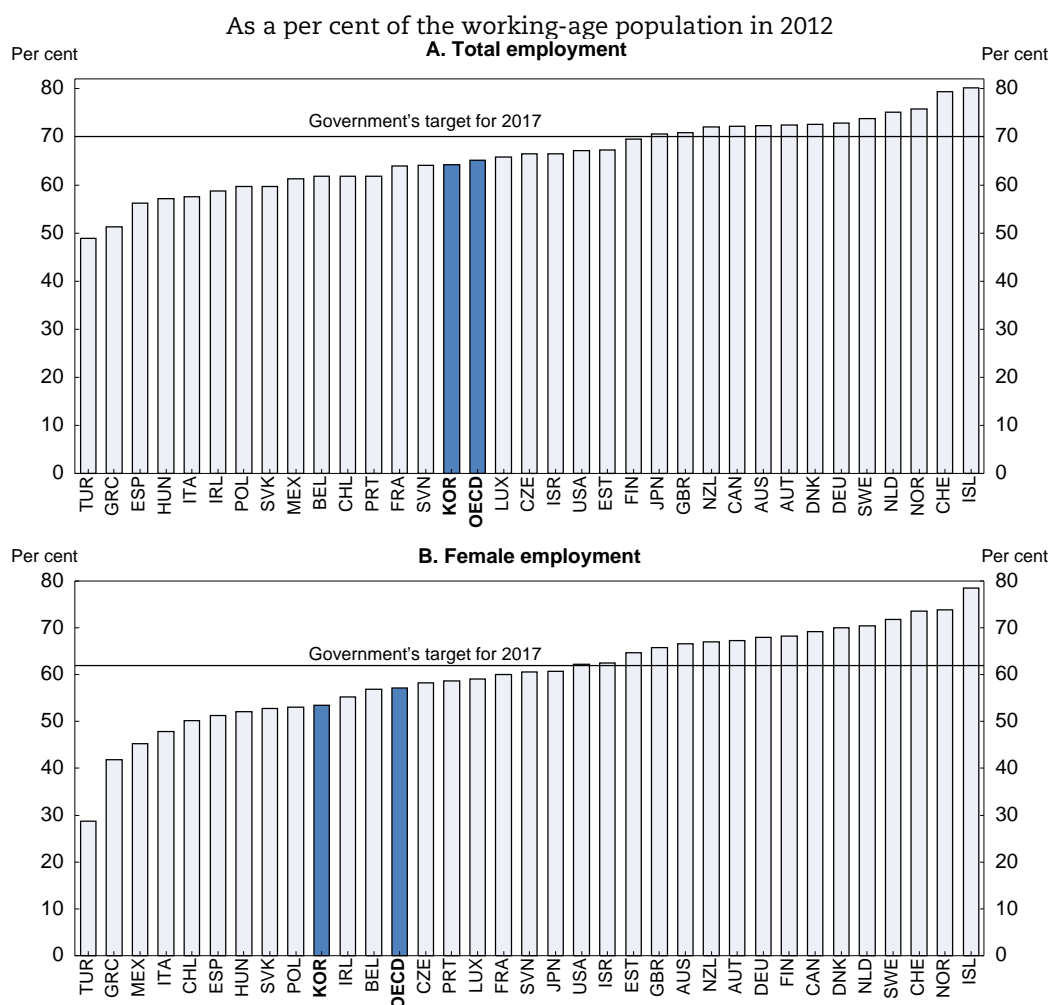
	2012	2017
Total	64.2	70.0
Women	53.5	61.9
Men	74.9	78.1
Youth (15 to 29)	40.4	47.7
Adults (30 to 54)	75.6	81.0
Older persons (55 to 64)	63.1	67.9

*Source:* Government of Korea.

Most importantly, achieving the 70% target will require breaking down barriers to women in employment and entrepreneurship, which is essential to mitigate the impact of rapid population ageing as well as to increase fairness. Female employment was 53.5% of the female working-age population in 2012, the tenth lowest in the OECD (Figure 17). Given the high level of education – 64% of women in the 25-34 age category had a tertiary education in 2011, the second highest in the OECD – low female participation implies that Korea is not fully utilising its human capital. The relatively low number of part-time jobs is one factor behind low female participation; in 2011, 19% of Korean women worked part-time as against the OECD average of 26%. In Korea, part-time work is classified as non-regular employment, which means lower hourly wages, making it less attractive, particularly for highly-educated women. The roadmap sets an objective of expanding the number of part-time jobs from 1.5 million in 2012 to 2.4 million in 2017. It is essential to create “high-quality” part-time employment that is treated as regular employment.

The low female employment rate reflects the withdrawal of a majority of women at the time of marriage or childbirth, although most return later. The withdrawal reflects the challenge of combining employment with family responsibilities. On average across OECD countries, women devote two hours more per day than men to unpaid household work, but in Korea the gap is three hours. Greater gender equity in unpaid work would help achieve the government's female employment target of 61.9% in 2017 (Table 4). The gender gap in earnings also discourages female employment. In 2011, female employees were paid only 64% as much as males, the largest gap in the OECD, reflecting the high share of women in non-regular jobs and the low share in management. It is necessary to create better job opportunities for women, in part by reducing dualism and expanding the role of performance, rather than seniority, in setting wages. In short, reforms are needed to offer women the hours, jobs, wages and careers that would encourage them to work.

**Figure 17. Korea's employment rate lags behind the most advanced countries**



Source: OECD Employment Outlook 2013.

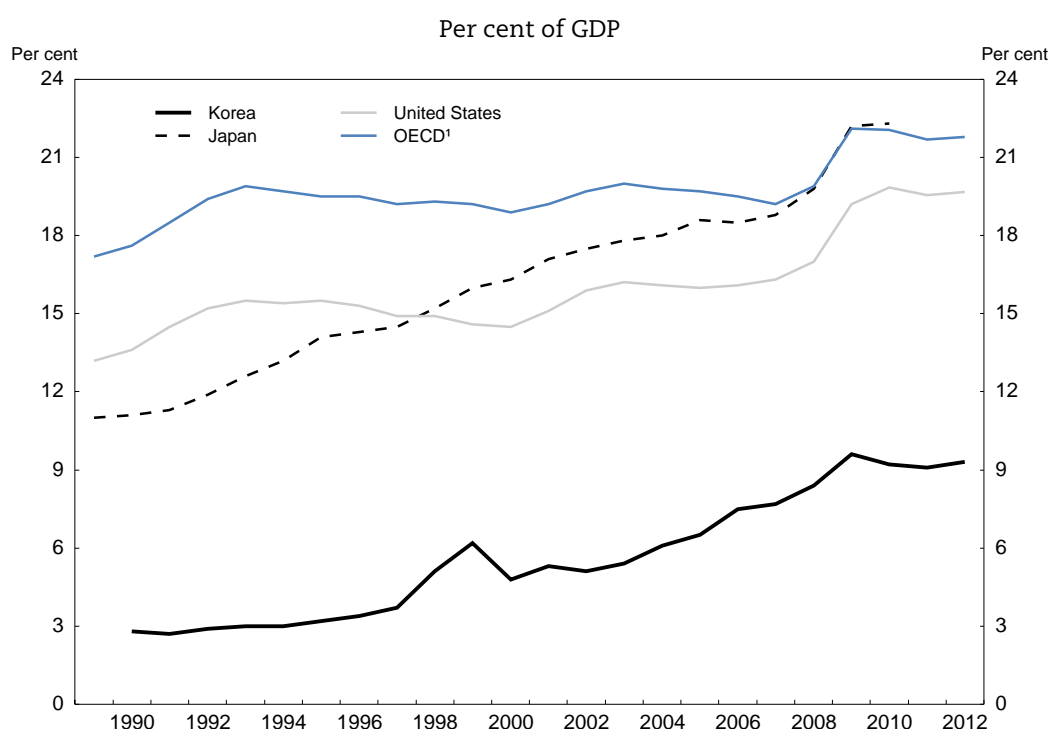
Finally, it is important to improve early childhood education and care (ECEC). Korea faces the intertwined problems of lower-quality childcare, a lack of places in higher-quality public centres and the cost of ECEC. A range of policies would help improve quality: *i)* raise the proportion of children attending kindergarten in private institutions by expanding tuition subsidies and increasing the capacity of public kindergartens; *ii)* improve the quality of private childcare by upgrading accreditation and making it mandatory and enhancing the quality of staff by increasing their educational requirements; *iii)* relax fee ceilings on private childcare to improve quality, while adjusting subsidy levels to avoid increasing the burden on low-income parents; *iv)* effectively implement the common curriculum for childcare and kindergarten; and *v)* gradually integrate childcare and kindergarten to improve quality, while reducing costs.

### **Strengthening the impact of social welfare programmes**

The redistributive impact of Korea's tax and transfer system is among the weakest in the OECD, reflecting low public social spending, at 9.3% of GDP in 2012 (Figure 18) and poor targeting, although it has improved over the past decade. Addressing poverty requires improving the three pillars of the safety net – the Basic Livelihood Security Programme (BLSP), unemployment insurance and the earned income tax credit (EITC). The BLSP provides a cash benefit and in-kind support, for example for health care and

education, to eligible persons in absolute poverty, defined in Korea as an income below the minimum cost of living (MCL) set by the government. The MCL is 40% of the national median income. However, BLSP support is limited by strict eligibility criteria on asset ownership and the “family support obligation rule”, which excludes those with the possibility of family assistance. Currently, benefits are provided to 1.4 million (3% of the population), well below the 7-8% in absolute poverty (OECD, 2013i). The number of BLSP recipients is projected to rise to 1.8 million following an easing of the eligibility criteria and a planned increase in the threshold for receiving in-kind allowances from 40% to a range of 40% to 50% of the national median income. Further relaxing the eligibility criteria would include more of the population in absolute poverty.

**Figure 18. Public social spending in Korea is relatively low**



1. Unweighted average. Data are available for 34 OECD countries from 2000. Data prior to 2000 have been interpolated backwards to calculate an average for 23 OECD countries.

Source: OECD Social Expenditure Database.

The EITC, which was introduced in 2008, covers 4% of households, with total payments of 0.2% of government spending. Although it was recently extended to single persons and some self-employed workers, the EITC's impact in encouraging work and reducing poverty is limited by its low benefit level and tight targeting compared to similar systems in other OECD countries (OECD, 2013i). Extending the EITC to more low-earning households, including the self-employed, and raising its generosity would strengthen its impact.

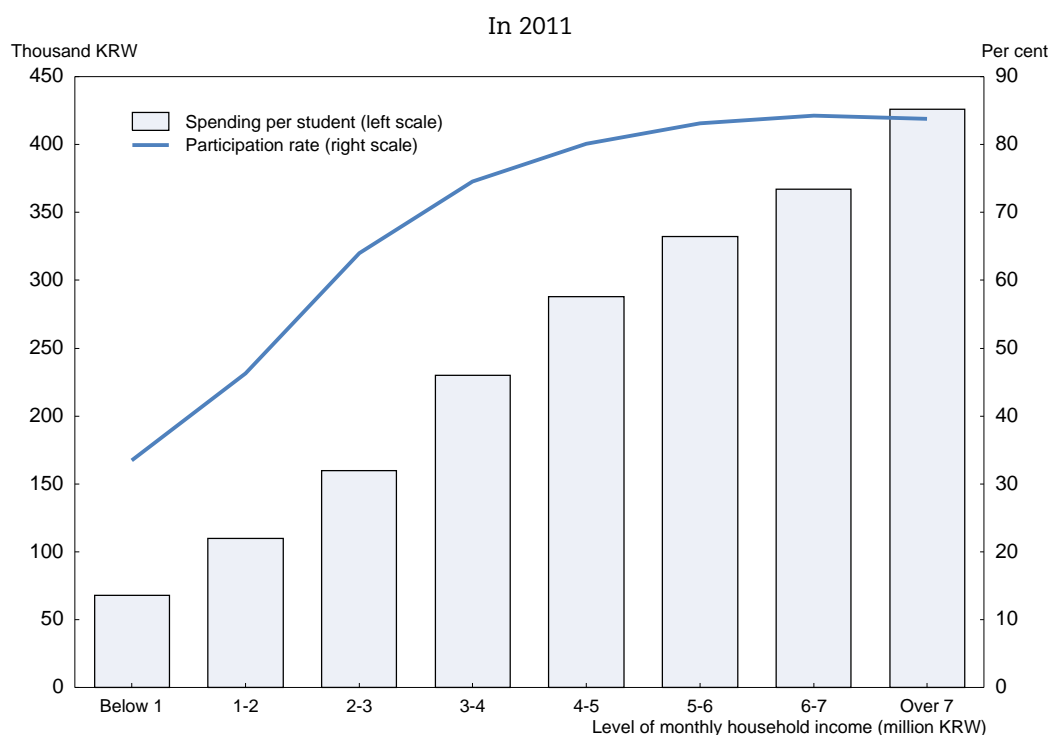
However, Korea needs to be cautious in raising social spending, given that demographic factors will put strong upward pressure on outlays, as noted above. The revenue to finance rising social spending should be met by pro-growth tax reforms. In particular, the personal income tax base, which covers only one-half of wage income, should be broadened while the role of indirect taxes – notably the VAT and environmental taxes – should be increased (see the tax chapter in the 2008 *OECD Economic Survey of Korea* or Jones, 2008b).

## Reforming education to promote social cohesion

Private spending on education in Korea is around 38% of the total, largely reflecting expenditures on private colleges and universities. This is almost double the OECD average of 20%, even before taking account of large outlays for after-school tutoring, notably in *hagwons*. Consequently, students' socioeconomic background is strongly correlated with the quality of the tertiary institution they attend. Indeed, the share of students participating in after-school tutoring is the second highest among OECD countries (OECD, 2013h). Participation and spending on private tutoring are highly correlated with family income (Figure 19). Equal opportunity is undermined by the heavy reliance on private tutoring to enter high-ranking universities, which has an inordinate impact on job prospects and future income. The role of private tutoring, which creates cycles of poverty and wealth that endure over generations, should be scaled back by:

- Reducing the importance of the multiple-choice university entrance exam, while increasing the role of the “school records system”, which gives greater weight to other criteria.
- Improving the quality and diversity of schools, thereby enabling students to acquire sufficient education without participating in private tutoring.
- Expanding access to public after-school tutoring by further expanding Internet and broadcast teaching systems and increasing after-school programmes in schools.
- Strengthening vocational education to reduce the over-emphasis on higher education (see above).

**Figure 19. Household income is closely linked with outlays and participation in private tutoring**



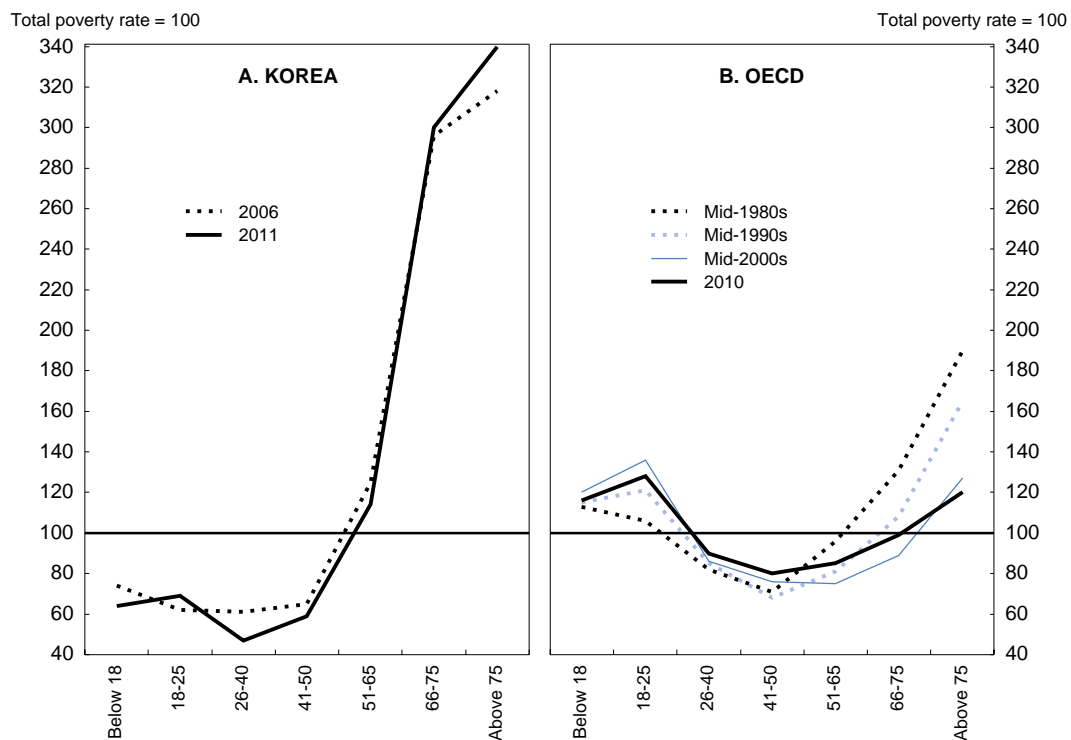
Source: OECD (2014b).

## Reducing the high rate of poverty among the elderly

### The rate of poverty among the elderly is the highest in the OECD

In 2011, 49% of the population aged 65 and over lived in relative poverty, nearly four times higher than the OECD average of 13%. The elderly poverty rate was three times greater than the 15% rate for the entire population, in contrast to the OECD area, where it is almost equal (Figure 20). Although there are no official data on the share of elderly in Korea in absolute poverty, it may be around 26% (1.5 million persons) (MHW, 2013). Many elderly had assumed that their children would provide for them, thus making it unnecessary to prepare financially. However, the number of elderly living alone has risen by 2.5 times since 2000 and now accounts for a quarter of all elderly. Rising poverty contributed to an increase in suicide among those over age 65 from 34 (per 100 thousand persons) in 2000 to 72 in 2010, far above the OECD average of 22 (Figure 21), with financial difficulty the major cause, according to a government survey (Statistics Korea, 2010).

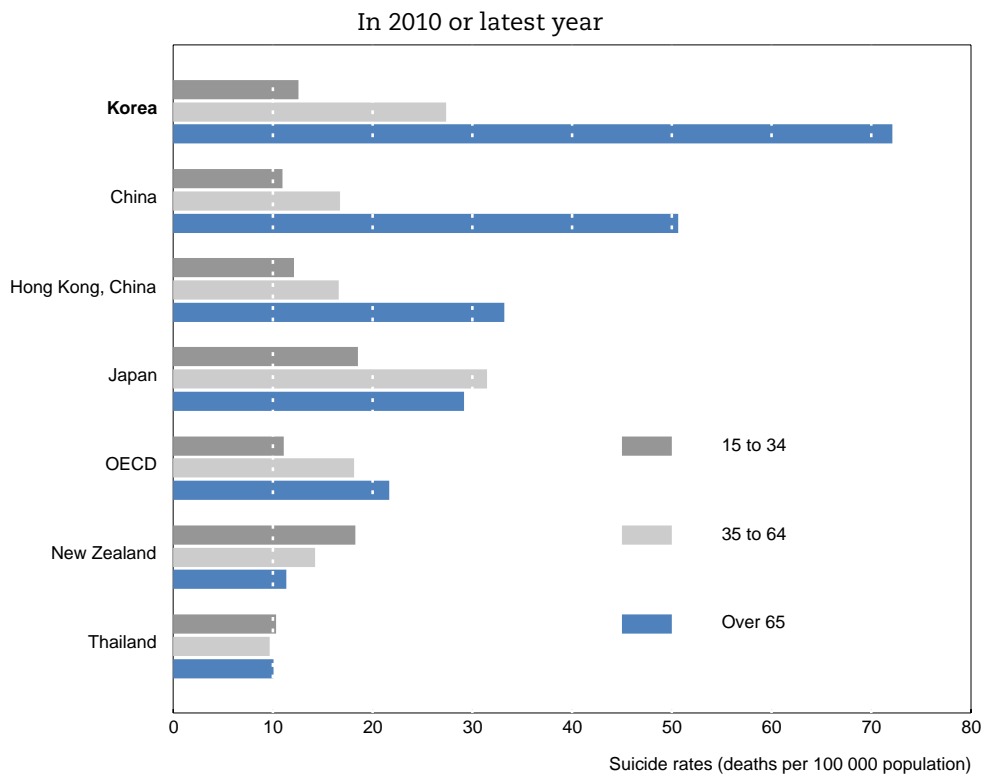
Figure 20. Relative poverty rates by age group<sup>1</sup>



1. The figure shows the poverty rate for each age group using an index, with the rate for the entire population set at 100. The poverty threshold is set at 50% of median income of the entire population. The OECD average includes 20 member countries.

Source: OECD Database on Income Distribution and Poverty.

**Figure 21. The suicide rate of the elderly in Korea is the highest in the OECD area**



Source: OECD (2011).

The high elderly poverty rate is thus an urgent social problem that reflects both the decline in family support and the weakness of other private and public sources of old-age income support:

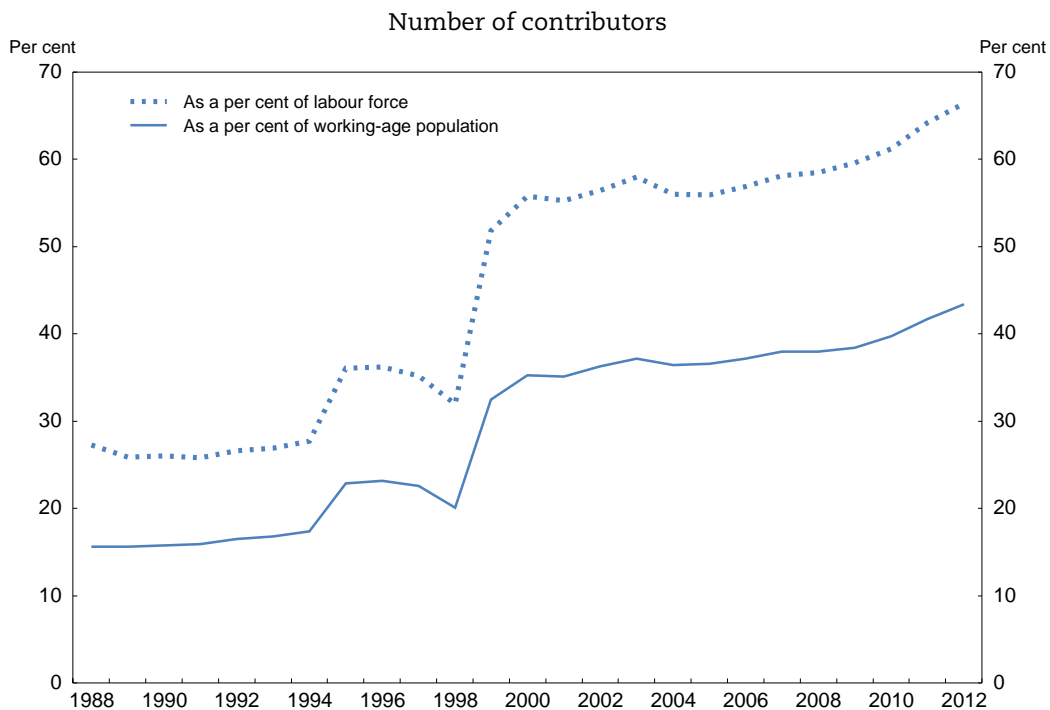
- The National Pension Scheme (NPS), created in 1988, provided old-age pension benefits to only 28% of the elderly in 2011. Moreover, pension benefits were only 10% of the average wage.
- The Basic Old-Age Pension System (BOAP) provides a small benefit equal to about 3% of the average wage to around 70% of the elderly. The BOAP thus spreads resources very thinly over a large segment of the older population.
- The company pension system introduced in 2005 covered 46% of employees who had worked for at least a year (12% of the working-age population) in 2012 and paid pension benefits to only about 3% of those enrolled.
- The BLSP provides social welfare benefits to about 6.3% of the elderly. Coverage is limited by the criterion that excludes elderly with the possibility of assistance from family members. However, elderly parents can no longer expect as much support from their children as in the past.

Rapid population ageing and the rising number of single elderly persons will exacerbate poverty. The immediate priority is well-targeted social spending to ensure an adequate minimum level of income for the elderly. As noted above, the BLSP reforms are projected to increase the number of beneficiaries (of all ages) by 400 thousand, which will have a limited impact on the number of elderly in poverty. Moreover, the 2014 legislation to double the BOAP benefit to 200 thousand won (\$193), while maintaining its broad coverage, is also likely to have a limited effect on elderly poverty. Given that the small share of elderly receiving the BLSP is projected to rise only modestly, the government should focus the BOAP on the lowest-income elderly to ensure that they escape from absolute poverty (an income below 40% of the national median income). With the increase in the BLSP threshold from 40% to between 40% and 50%, it

could be used to top up the income of poor elderly. In addition, the criterion that excludes those with the possibility of family support should be further relaxed.

It is important to make the NPS more effective in reducing poverty in the long run. According to the government's 2013 projection, only 40.9% of the elderly will receive NPS pensions in 2030 and the pension amount will be kept low by the plan to reduce the targeted replacement rate for those with 40 years of contributions from 50% to 40%. Moreover, the average contribution period of recipients over 2030-40 will be less than 20 years, reducing the actual replacement rate to less than 20%. A three-pronged approach is needed. *First*, the number of contributors should be increased. In 2012, only 43% of the working-age population paid contributions (Figure 22), well below the 80-100% rate in other advanced countries, reflecting lower compliance by the self-employed, non-regular workers and SME employees (Lee, 2012). *Second*, the average contribution period should be lengthened to increase the size of benefits. *Third*, the targeted replacement rate should be kept around 50%, although this requires raising the contribution rate to 16.7%, compared to 14.1% for a 40% replacement rate, to maintain a balanced budget through 2083.

**Figure 22. The coverage of the National Pension Scheme is low**

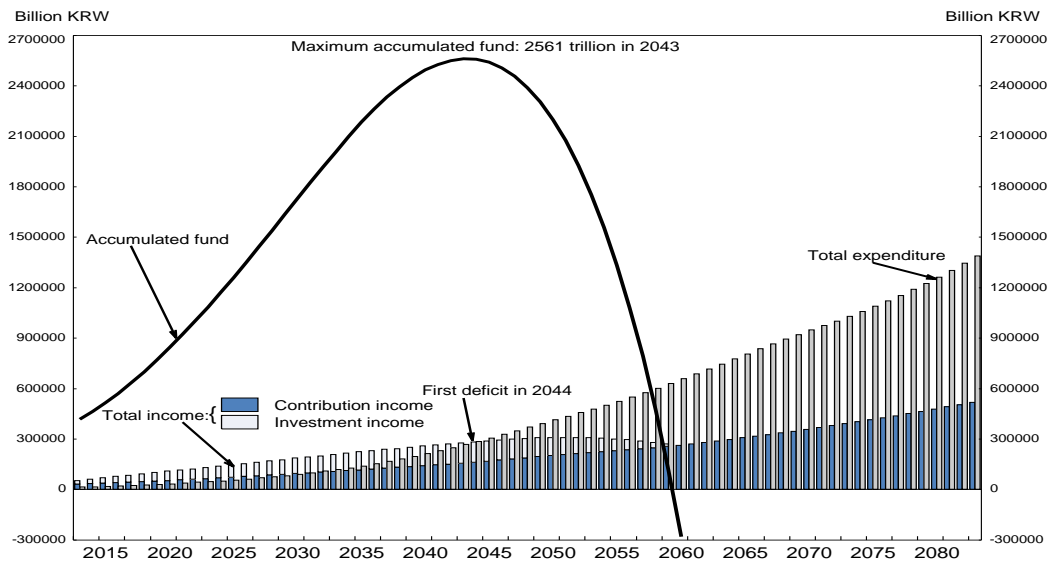


Source: National Pension Service and Statistics Korea.

Even with the cut in the replacement rate to 40% and the planned hike in the pension eligibility age from 61 to 65 in 2033, NPS spending is set to rise much more than revenue (Figure 23). There are three options to sustain public pension systems: cutting benefits, raising the pension eligibility age and increasing revenue. A 40% targeted replacement rate would be too low, given the short average contribution period, as noted above. A more rapid hike in the pension eligibility age, under current labour practices, would create hardship by lengthening the gap between when workers leave firms and when they can receive a public pension. In this regard, the decision to raise the minimum age for mandatory retirement to 60 in big firms from 2017 is a step in the right direction.



**Figure 23. The National Pension Scheme is projected to fall into deficit in 2044**



Source: National Pension Research Institute (2013).

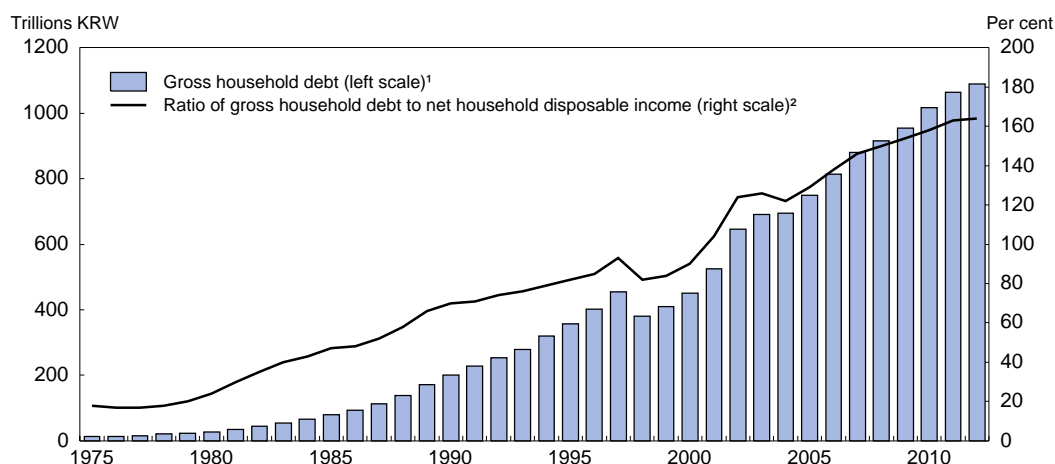
The best option, therefore, is to raise more revenue, preferably by raising the contribution rate from its relatively low level of 9%. This has helped limit Korea's marginal tax wedge on labour, which is the third lowest in the OECD area. While some countries rely on general tax revenue to finance pensions, such an approach would not be appropriate in Korea, given that only 40.9% of the elderly will receive an NPS pension in 2030. Relying on general tax revenue would, in effect, transfer income from low-income persons, such as non-regular workers and those in SMEs, who are less likely to participate in the NPS, to higher-income persons. The government projects that maintaining a balanced budget through 2083 would require boosting the contribution rate to 14.1% by 2015. The adjustment of the contribution rate should begin as soon as possible, as delays would only make the necessary increase larger.

Achieving adequate income for the elderly requires a multi-pillar approach based on a social consensus. In addition to reforming the NPS, it is important to increase private savings by developing the company pension system and individual pension savings. The introduction of company pensions has been hindered by workers' attachment to the so-called retirement allowance – which requires firms to pay departing employees a lump-sum separation payment equivalent to at least one month of wages per year of work. The government has recently reduced the favourable personal income tax treatment of the retirement allowance. It will be important to assess the effectiveness of this measure in promoting the adoption of company pensions. Individual Pension Accounts should also be strengthened, in part by increasing the penalties for early withdrawal prior to retirement and providing more favourable treatment of existing contracts.

### *Coping with high household debt*

Rising household debt has become a major policy concern (Figure 24). In addition to the economic impact and the risk to the financial sector, it raises social cohesion issues, as financial institutions have become increasingly reluctant to lend to low-income households and delinquent borrowers have lost access to financial markets. According to a survey, a quarter of indebted households borrow money to pay for living costs, reflecting in part Korea's undeveloped social safety net. Low-income households tend to borrow from consumer finance companies at high interest rates, including unregistered companies that charge an average interest rate of 53%.

**Figure 24. Gross household debt has risen sharply**



1. In real terms, adjusted by the 2010 CPI.

2. In current prices. Data are based on SNA1993.

Source: Bank of Korea.

In 2011, the government announced a plan to “induce the soft landing of household debt”. The objective is to gradually reduce the household debt ratio, while avoiding a sharp deleveraging. To achieve the goal, the government has strengthened prudential measures on financial institutions. In addition, it is trying to reduce the risk attached to household debt, particularly mortgage loans, which account for one-half of household debt. Given the higher default risk attached to floating-rate and “bullet repayment” loans, their share should be reduced in favour of fixed-term and instalment payment mortgages. The household debt ratio levelled off in 2012.

The government is addressing the social dimension of household debt by expanding support for individuals with low income and credit ratings. Since 2008, 1.4 million people have received preferential loans with interest rates of 5% to 10%, well below the market rate of over 20% on consumer loans. However, the delinquency ratio of these programmes has risen, even though they carry low interest rates. The preferential loans should not be regarded as free money and should be limited to those who have the ability and intention to repay. For debtors unable to service preferential loans, social welfare programmes would be more effective and would prevent an additional run-up in debt.

The government has also expanded debt restructuring programmes for delinquent borrowers. Since 2008, such programmes have assisted nearly one million delinquent borrowers, helping to reduce the number from 2.3 million in 2008 to 1.1 million, which is still about 5% of households. The most important programme is the National Happiness Fund, which writes off up to 70% of debt and interest, depending on the debtor’s situation. This may create moral hazard by raising expectations that the government will repeat such policies in the future. It is important, therefore, that the authorities maintain their pledge not to repeat such large-scale write-offs. At the same time, consumer financial education should be enhanced to help households carefully examine whether they can service their debt and to seek alternative solutions, such as social welfare. In addition, lenders should make loans on the basis of careful credit evaluation as they also bear responsibility when debtors default.

The long-run goal should be to reduce the government’s role and develop a market-based system to provide credit to households with low income and poor credit ratings, along with a stronger social safety net. Such a system depends on financial institutions gaining experience in such lending to enhance their ability to assess risk. Given that banks have little interest in lending to individuals with low income and poor credit ratings, the role of small non-bank financial institutions, such as mutual saving banks and mutual credit institutions, in lending to such households that are credit-worthy should be encouraged. This would reduce the role of finance companies, which charge substantially higher interest rates on household loans.

### **Box 3. Key policy recommendations to promote social cohesion and well-being**

Reducing poverty, particularly among the elderly

- Target the Basic Old-Age Pension benefit on the lowest-income elderly to ensure that they escape from absolute poverty.
- Increase the coverage of the National Pension Scheme and maintain the replacement rate at around 50%. Raise the contribution rate to meet rising pension outlays.
- Expand private savings for retirement by accelerating the introduction of company pensions and strengthening personal pension plans.

Other areas

- Break down labour market dualism by reducing employment protection for regular workers and by increasing social insurance coverage and training for non-regular workers.
- Address the household delinquent debt problem while limiting moral hazard and containing the growth of household debt.
- Raise the employment rate, particularly for women, by creating high-quality part-time jobs and improving the quality of childcare.

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# ANNEX A1

## THE THREE-YEAR PLAN FOR ECONOMIC INNOVATION

### The background of the Plan

President Park Geun-hye took office in February 2013 calling for a “second miracle on the Han River”. On 25 February 2014, the first anniversary of her inauguration, President Park announced the details of a Three-year Plan for Economic Innovation that is to play a central role in this regard. The Plan is aimed at revitalising the Korean economy and achieving 4% potential growth, a 70% employment rate and \$40 thousand per capita GDP (compared to \$26 thousand in 2013) – as announced by the President at her New Year’s address in January.

The Plan comes after several years of sluggish growth. Decisive measures are needed to establish a more dynamic and innovative economy through structural reforms to avoid falling into a low-growth path. As discussed in the *Survey*, Korea has grown rapidly from one of the poorest countries in the world to an advanced economy based on a catch-up strategy centred on input-driven growth. The government acknowledges that the traditional growth strategy, which focused on exports by large companies and depended on imports of technology, has reached its limit. Moreover, it has led to imbalances, for example between exports and domestic demand, manufacturing and services, *chaebols* and SMEs, and regular and non-regular workers. The government that took office in 2013 is seeking a new paradigm based on creativity and innovation. To achieve this objective, the government launched its “Creative Economy” initiative in 2013 and more specific measures are now fleshed out in the broader and more detailed Three-year Plan.

### The main contents of the Three-year Plan for Economic Innovation

The overriding objective of the Plan is to accomplish “an era of happiness for the people”. The Plan sets three strategies – an economy with strong fundamentals, dynamic innovation and a balance between domestic demand and exports (Figure A1.1). Each strategy has three tasks, with preparing for reunification added as the tenth task.

**Figure A1.1. The Three-year Plan for Economic Innovation**

Objective	Accomplishing an era of happiness for the people		
3 Major strategies	Economy with strong fundamentals	Economy with dynamic innovation	Economy with a balance between exports and domestic demand
9 + 1 Tasks	1. Reform the public sector	4. Develop creative industries	7. Improve the investment environment
	2. Build a rule-based market economy	5. Invest for the future	8. Strengthen domestic demand
	3. Establish a strong social safety net	6. Make inroads into overseas market	9. Encourage the labour force participation of youth and women
	10. Prepare reunification		

Source: Ministry of Strategy and Finance (2014).

### The first strategy: an economy based on strong fundamentals

The first strategy includes the tasks of reforming the public sector, developing a rule-based market economy and building a strong social safety net (Chapter 2 of the *Survey*).

The government will reform the public sector, which has been plagued by inappropriate practices and low productivity, due to lax management, high debt ratios and various types of rent-seeking behaviour. By introducing competition between public institutions, as well as with the private sector, the



productivity of public institutions is to be enhanced. State-owned enterprises will be required to reduce their debt-to-equity ratios from an average of 239% in 2013 to 200% in 2017 by streamlining their activities and selling assets. In addition, ceilings on bond issuance will be introduced. To improve management, public institutions will be required to disclose all information, excluding confidential data and business secrets. Public-sector efficiency is to be enhanced by eliminating 600 overlapping government programmes during the next three years. Finally, the occupational pensions for civil servants, the military and teachers, for which government spending is rising, will be reformed.

A new public/private taskforce will monitor progress in restoring fairness and produce semiannual reports. The rules governing the Korean economy are to be strengthened to restore fairness between economic entities, such as large companies and small and medium-sized enterprises (SMEs), employers and employees, and producers and consumers. For example, measures to ensure fair trading between large companies and SMEs are to be enhanced based on the legislation passed in 2013 to promote economic democracy. The government will also try to narrow the wage gap between regular and non-regular workers by promoting wage systems based on ability and productivity rather than on type of employment. The gap in employment protection between regular and non-regular workers will be narrowed by strengthening requirements for laying off non-regular workers, as well as rationalising regular workers' protection. In addition, an independent agency to promote consumer financial protection will be established.

The social safety net will be strengthened. The earned income tax credit will be expanded to provide greater incentives to work. The coverage of unemployment insurance will be increased – at present only 45% of employees are protected by unemployment insurance. In addition, the size of unemployment benefits will be adjusted to enhance work incentives. The coverage of the “Hope Growing Account”, in which the government matches the saving of poor persons to help them accumulate assets, will be expanded to households with an income between 100% and 120% of the minimum cost of living.

## The second strategy: a dynamic economy based on innovation

This strategy reinforces the government's 2013 initiative to foster a “creative economy” (Chapter 1 of the *Survey*). The goal is to change Korea's economic paradigm by developing creative industries, investing in the future and expanding Korea's presence in overseas markets.

Venture businesses and SMEs are the core of a creative economy. To improve the business environment for them, the government will inject 4 trillion KRW (\$3.9 billion) by 2017. This investment will include start-up funds for young entrepreneurs and angel investment. In addition, the government will launch a new fund, modeled on Israel's *Yozma Fund*, with global venture capital companies to invest in Korean start-ups. To encourage foreign investor participation, they will be allowed to buy the government's share at a low price and the government will be the first to bear losses. The government will also establish 17 “Creative Economy Innovation Centres” in major cities by 2015. The Centres are to become the focal point of regional development by supporting start-ups through a range of services including education, technology development and financing. The Centres will be supplemented by on-line “Creative Economy Towns”. A “technology bank” will also be introduced to warehouse unused ideas, patents and knowhow developed by government research institutions and companies so that they can be used by entrepreneurs and start-up companies.

R&D investment, which was the highest in the OECD at 4.4% of GDP in 2012, is to be increased to 5% by 2017. In addition, international collaboration in innovation is to be strengthened, in part through the creation of the Korea Research Fellowship to attract foreign researchers. The government plans to invite 300 world-class scientists and researchers by 2017 by providing competitive financial support and guaranteeing a sufficiently long stay in Korea. In addition to supporting economic growth, the foreign experts are to enhance the R&D capabilities of local universities. The government will also provide more tax breaks on capital gains resulting from technology transfers, in an effort to boost trade in intellectual property rights. Finally, the government plans to promote the development of the Internet by ensuring that investments to advance network infrastructure are made in a timely manner.

The government will introduce policies to promote exports by smaller firms. At present only 2.7% of SMEs export. Korea currently has free trade agreements (FTAs) with countries accounting for around 55% of world GDP. The coverage is to be raised to 70%, in part by completing an FTA with China.



## The third strategy: an economy balanced between domestic demand and exports

To create a more balanced economy, the Plan focuses on boosting domestic demand, improving the investment environment and raising the employment rate.

Structural weaknesses constraining domestic demand will be addressed. Household debt, which rose to 164% of household disposable income in 2012, one of the highest in the OECD, is to be lowered by 5 percentage points by 2017 through enhanced financial supervision and regulation. At the same time, preferential loan programmes for low-income people will be expanded. In order to lessen the burden of housing costs, notably the increasing cost of *chonsei* deposits, the government plans to increase the supply of rental housing through deregulation and tax incentives for private investors.

The government will promote ambitious regulatory reform to promote business investment. The total burden of regulation is to be capped by introducing a “one-in, one-out” system; whenever a new regulation is introduced or existing regulations are strengthened, other regulations should be abolished or relaxed. Moreover, the overall level of regulation is to be reduced by requiring that even more existing regulations be relaxed in line with newly-introduced regulations and by strengthening the sunset clause for existing regulations. A cabinet committee on regulatory reform, led by the President, is to be launched to promote deregulation. For five promising service industries – health, education, finance, tourism and software – all regulations are to be reviewed. Moreover, a joint public-private task force is to provide one-stop services for investors in these industries.

The emphasis on labour force participation is in line with the roadmap to boost the employment ratio to 70% of the working-age population. The government will promote the creation of 1.5 million jobs for women and 500 thousand for youth. In order to promote female labour force participation, the government will focus on providing flexible childcare services and strengthening financial and legal support for part-time jobs. For instance, the right to work reduced hours will be expanded for employees who have clear reasons, such as childcare, pregnancy and nursing of young infants. The hourly wage for parents who reduce their working time to take care of children will be raised from 40% of the normal wage to 60%, using financing from the employment insurance system. Part-time workers will have the first opportunity to get information on recruitment when their firms want to expand the number of full-time workers. For youth, the priority is to improve vocational education and solve the labour market mismatch problem. The National Competency Standards, which currently number 286, will be expanded, and educational programmes, credential systems and human resource management are to be developed based on the Standards. The government will also further expand the opportunities for high school graduates to study while working by providing more incentives to schools and companies that participate in this effort. For example, firms that participate in vocational education programmes will receive additional tax benefits.

## Preparing for the reunification of Korea

The government will set up a Presidential Reunification Preparation Committee to prepare for the reunification of the Korean peninsula and expand inter-Korean exchanges and dialogue (Annex A.2). Experts and civic group representatives from various sectors including foreign affairs, security, economy and culture will be appointed to the Committee, which will develop a detailed blueprint of a unified Korea.

## An evaluation of the Plan

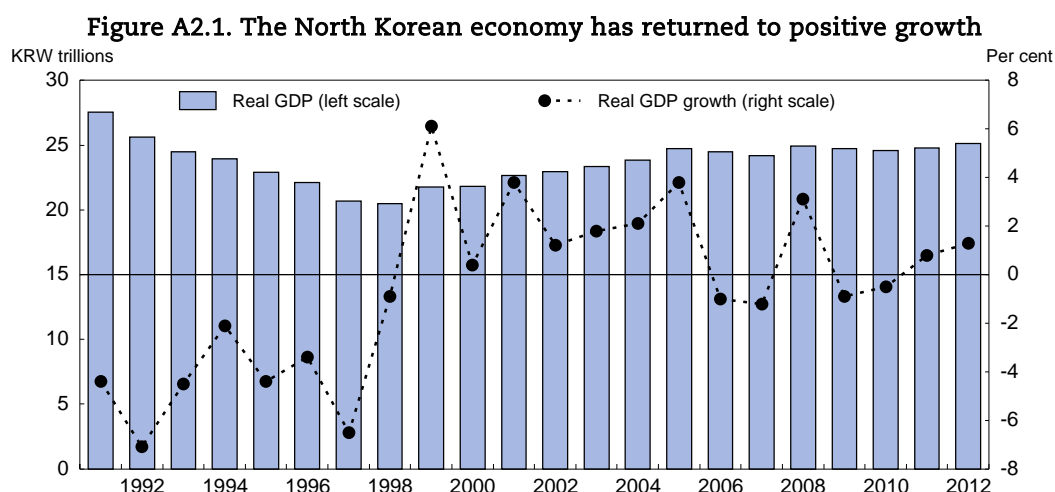
This comprehensive Plan includes bold structural reforms that are needed to boost Korea's growth potential and avoid falling into a low-growth trap. It follows the main themes of President Park's first year in office, namely fostering a creative economy, promoting social cohesion and boosting the employment rate. Most of the measures are consistent with the recommendations in the *Survey*. Some of the targets will be challenging to achieve.

The Plan addresses many longstanding problems in the Korean economy that have not been resolved due to strong resistance from interest groups. The personal involvement and commitment of the President and her promise to personally monitor progress will hopefully lead to greater success in addressing these issues.

## ANNEX A.2

### ECONOMIC CO-OPERATION WITH NORTH KOREA

After declines in 2009-10, the North Korean economy grew during 2011-12, thanks primarily to a rebound in agriculture, which accounts for a quarter of GDP (Figure A2.1). However, compared to the early 2000s, output growth was weak. Consequently, the gap between the two Koreas is enormous. Indeed, South Korea's economy was 38.2 times larger than the North's in 2012 and 18.7 times larger on a per capita income basis, raising concern about the potential cost of economic rapprochement (Table A2.1).



Source: Bank of Korea.

**Table A2.1. Comparison of North and South Korea in 2012**

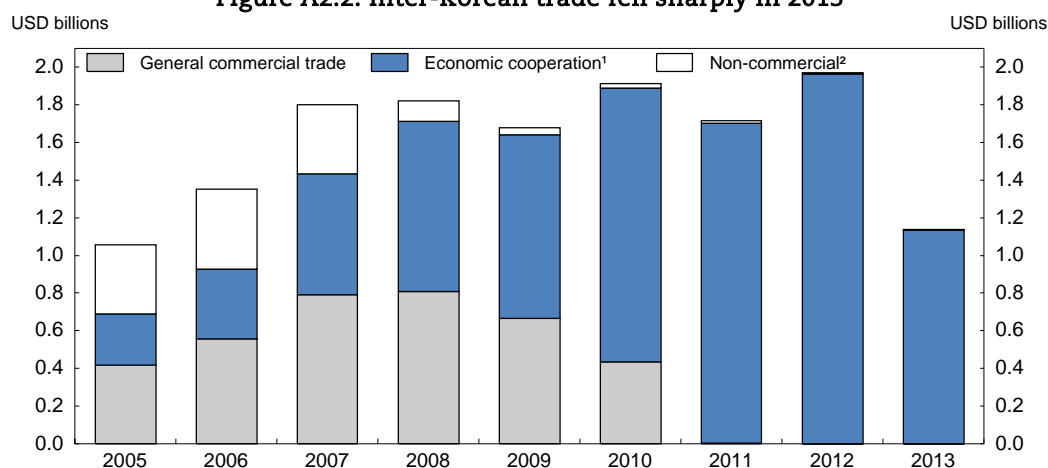
	(A) North Korea	(B) South Korea	Ratio (B/A)
Population (millions)	24.4	50.0	2.0
GNI (trillion won)	33.5	1 279.5	38.2
GNI per capita (million won)	1.3	25.6	18.7
Total trade (billion US\$)	6.8	1 067.5	157.0
Exports	2.9	547.9	188.9
Imports	3.9	519.6	133.2
Of which: inter-Korean exports <sup>1</sup>	1.1	0.9	0.8
Industrial statistics (2012)			
Power generation (billion kWh)	21.5	509.6	18.6
Steel production (million tonnes)	1.2	69.1	56.5
Cement production (million tonnes)	6.4	46.9	7.3
Agricultural production (2012)			
Rice (million tonnes)	1.9	4.9	2.6
Fertiliser (million tonnes)	0.5	2.6	5.4

1. North Korean exports to the South in column Panel A, and South Korean exports to the North in column B.

Source: Statistics Korea.

The North Korean economy has been negatively affected by a sharp fall in economic co-operation with the South since 2008 amid political tensions. After the fatal shooting of a South Korean tourist at the Mount Geumgang resort in 2008, South Korea ended the tourism programme. The sinking of a South Korean warship in 2010 prompted the South to suspend investment in the North and inter-Korean trade, excluding that related to the Gaesung Industrial Complex. As a result, commercial and non-commercial trade ceased by 2012 (Figure A2.2). Trade was also reduced by the North's closure of Gaesung for five months in mid-2013. Consequently, total inter-Korean trade dropped sharply from \$2 billion in 2012 to \$1.1 billion in 2013, a level not seen since 2005.

**Figure A2.2. Inter-Korean trade fell sharply in 2013**



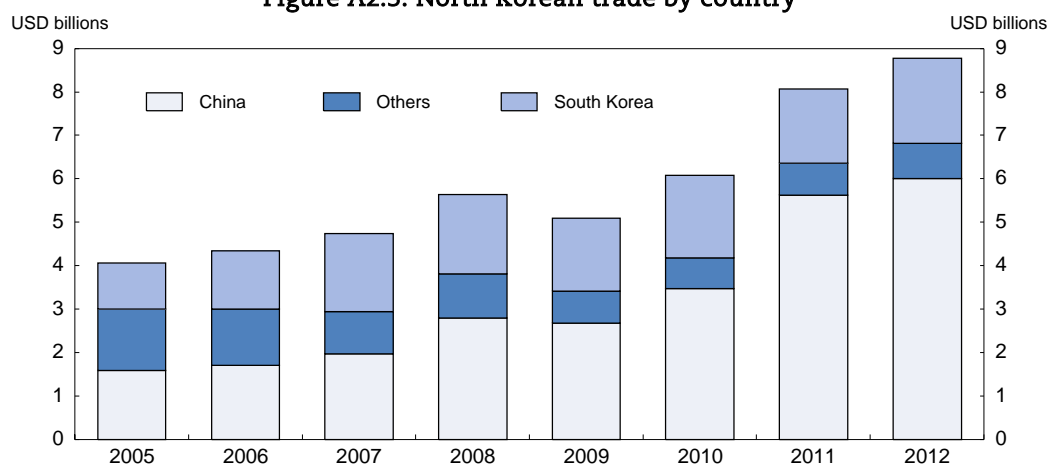
1. Includes special projects, such as the Mount Geumgang resort and the Gaesung Industrial Complex.

2. Primarily humanitarian aid.

Source: Ministry of Unification, Seoul.

With North-South economic relations declining, North Korea has significantly expanded its trade with China. In 2007, South Korea and China each accounted for about 40% of North Korea's trade. By 2012, China's share had risen to 68% while South Korea's fell to 22%. In addition to expanding trade, the North Korean government has pursued a number of economic co-operation projects with China. For example, it is creating special economic zones on Hwanggumpyong Island, a border city that handles three-quarters of the trade between North Korea and China, and Raseon, a city on the eastern coast of North Korea, just 20 kilometres from the border with China.

**Figure A2.3. North Korean trade by country**



Source: Korea Trade-Investment Promotion Agency and the Ministry of Unification, Seoul.

# Chapter summaries

## Chapter 1. Fostering a creative economy to drive Korean growth

A creative economy requires innovation-friendly conditions. Korea's innovation system should be improved by upgrading universities and expanding their role in business R&D, while increasing international collaboration in R&D from its current low level. The returns from Korea's large investment in innovation should be enhanced by improving framework conditions – easing product market regulations, promoting international competition and enhancing labour market flexibility – to encourage the adoption of new technology. Venture businesses and start-ups should play a key role in commercialising innovation. To make venture investment a growth driver, it is important to expand the role of business angels, activate the merger-and-acquisition market and foster entrepreneurship. A creative economy also depends on making SMEs, which account for 87% of employment, more dynamic. SME policies should be streamlined and improved to promote market-based financing and reduce the negative effects of government funding programmes, which discourage the expansion of SMEs. The growth of small firms also depends on resolving labour market mismatches and taking full advantage of the opportunities afforded by the Internet.

## Chapter 2. Reducing income inequality and poverty and promoting social mobility

*To strengthen social cohesion, a top government priority, it is essential to address the labour market roots of inequality by breaking down dualism to reduce the share of non-regular workers and to boost the employment ratio toward the government's 70% target. Education reforms are also important to enhance social mobility. Social welfare programmes should be improved to make them more effective, especially among the elderly, where the relative poverty rate is 49%. In addition, reforms are needed now to develop an effective three-pillar system of retirement income based on the National Pension Scheme, company pensions and individual savings. High household debt also has adverse implications for equity, as well as for growth, as individuals with low income and credit ratings have limited access to financial markets and many are delinquent on their loans. Policies to offer credit to such households and restructure their debt, while limiting moral hazard and developing market-based lending, are essential.*

*This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

*The economic situation and policies of Korea were reviewed by the Committee on 17 March 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 18 April 2014.*

*The Secretariat's draft report was prepared for the Committee by Randall S. Jones, Myungkyoo Kim and Satoshi Urasawa under the supervision of Vincent Koen. Research assistance was provided by Lutécia Daniel.*

*The previous Survey of Korea was issued in April 2012.*

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